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THE CONUNDRUM OF CORPORATE GOVERNANCE

Cally Jordan[*]

I. INTRODUCTION

It has become a truism that the pressures of the capital markets will improve the governance of corporations; equally, that improvements in corporate governance will promote development of the capital markets. However, the relationship of the capital markets to the governance of corporations is neither simple nor linear; rather it is more in the nature of a complex feedback loop, a dynamic process responsive to many factors.

The efforts to identify the factors which promote capital market development and improvements in corporate governance have spawned a huge body of literature. Central to the discourse has been the role of legal systems and legal rules. The popularity and proliferation of international standards, among other factors, have resulted in massive transfers of legal information, but often the relative ineffectiveness of transplanted legal rules has proved a conundrum.

This article builds on previous literature looking at how to predict the effectiveness of transplanted legal concepts and the implications for corporate governance initiatives and capital market development. The recent economics literature has ignored the complexity and dynamism of legal systems. More tellingly, the "legal origins" literature has misunderstood the fundamental nature of the benchmark U.S. legal system, the genius of which, according to some commentators, resides in its combination of elements of both the common law and the civil law traditions.

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So, more discernment is needed in introducing new legal concepts, particularly in what are now sometimes referred to as "frontier economies," as well as greater attention being paid to the essential process of "indigenization." Even the form a legal rule takes can be as important as its substance. Indiscriminate mixing and matching of legal rules, such as that occurring in the aftermath of mass privatizations that marked the 1990s, can easily go awry. The result may be dysfunctional or unbalanced systems with unpredictable, and certainly unintended, consequences. At worst, perversities may occur, for example, where a deliberately ineffective rule is introduced domestically, seemingly in furtherance of the implementation of internationally recognized standards.

Adding to the complexity of the operation of formal legal rules is another complex layer, "legal sensibilities," an often ignored but essential element to the effectiveness of any legal rule. Fiduciary duties, for example, one of the cornerstones of Anglo-American corporate governance, are imbued with the legal sensibilities of a particular time and place and may travel badly, if at all, to other climes.

These observations may have some predictive value in gauging the potential effectiveness of any particular initiative. "Voluntary" codes and procedural remedies drawn from Anglo-American law, for example, may not be the most effective means of channeling market forces to the improvement of the governance of corporations in continental European-style legal systems. Governance mechanisms introduced in multiple guises along a continuum of private and public rule may amplify the prospects of effectiveness.

Finally, new models for markets and capital markets regulation are emerging in Europe, models that may be more compatible with the legal systems of much of the non-Commonwealth world.

II. The Debate

The events of the last fifteen years rival the South Sea Bubble and tulip mania in focusing popular attention on capital

markets and corporations.[1] There have been spectacular market surges and market failures accompanied by a panoply of regulatory and private sector responses. The intensity of the activity and its consequences have raised fundamental questions as to how capital markets, and financial systems generally, grow and develop and the role of corporate actors.

The efforts to identify the factors which promote capital market development and improvements in corporate governance have spawned a huge body of literature. Central to the discourse has been the role of legal systems and legal rules. Are some legal systems better than others in fostering financial sector development?[2] Can formal legal rules from such systems be transplanted to other systems to promote better corporate governance and the development of capital markets?[3] Will there be inevitable convergence of the rules of "weaker" legal systems to those of "stronger" legal systems?[4] Can international standards

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1. The recent 2004 release THE CORPORATION, a film by Mark Achbar, Jennifer Abbott & Joel Bakan, is an indication of the degree to which the debate has entered popular culture.

2. *See* Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998); Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000); Rafael La Porta et al., *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147 (2001). More recently, see LA PORTA ET AL., WHAT WORKS IN SECURITIES LAWS? (Tuck School of Bus., Working Paper No. 03-22, July 16, 2003), *available at* http://www.ssrn.com/abstract=425880 (last visited May 20, 2005). The legal origins literature referred to in this article is primarily based on the La Porta studies:

> Because legal origins are highly correlated with the content of the law, and because legal families originated before financial markets had developed, it is unlikely that laws were written primarily in response to market pressures. Rather the legal families appear to shape the legal rules, which in turn influence financial markets…legal rules do matter.

La Porta et al., *Investor Protection and Corporate Governance,* at 3. For a comprehensive discussion of the literature, see Katharina Pistor et al., *The Evolution of Corporate Law: A Cross-Country Comparison,* 23 U. PA. J. INT'L ECON. L. 791 (2002).

3. *See* KATHARINA PISTOR, PATTERNS OF LEGAL CHANGE: SHAREHOLDER AND CREDITOR RIGHTS IN TRANSITION ECONOMIES (European Bank for Reconstruction and Development, Working Paper No. 49, May 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=214654 (last visited May 20, 2005).

4. For discussions of the convergence theory, see William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and the Theory of*

be formulated to provide guidance to developing and transition economies, and if so, based on what?[5] And, the conundrum of corporate governance, why are "good" legal rules so often ineffective?

There are still more questions than answers:

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the Firm: The Case Against Global Cross Reference, 38 COLUM. J. TRANSNAT'L L. 212 (1999). *Cf.* JOHN C. COFFEE, COMPETITION AMONG SECURITIES MARKETS: A PATH DEPENDENT PERSPECTIVE 17 (Colum. Law School, Ctr. for Law and Econ. Studies, Working Paper No. 192, Apr. 2002), *available at* http://www2.law.columbia.edu/law-economicstudies/papers/wp192.pdf (last visited May 20, 2005); John C. Coffee, *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 N.W. U. L. REV. 641 (1999). In addition, Jeffrey N. Gordon and Mark J. Roe have recently published a collection of papers on the convergence debate in CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE (2004).

5. Both the International Organization of Securities Commissions (IOSCO) and the Organization for Economic Cooperation and Development (OECD) have been active in formulating influential standards in the area of capital markets and corporate governance. *See, e.g.*, IOSCO, *Objectives and Principles of Securities Regulation,* May 2003, *available at* http://www.iosco.org/pubdocs/pdf/IOSCOPD154.pdf (last visited May 20, 2005) (revising the 1998 *Objectives and Principles of Securities Regulation* and used extensively by the World Bank and the International Monetary Fund in their program of country Reports on the Observance of Standards and Codes (ROSCs), which have been conducted in dozens of countries to date); IOSCO, *International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers*, Sept. 1998, *available at* http://www.iosco.org/pubdocs/pdf/IOSCOPD81.pdf (last visited May 20, 2005) (which have formed the basis of both U.S. S.E.C. and E.U. regulatory initiatives); OECD, *Principles of Corporate Governance*, 2004 revision, *available at* http://www.oecd.org/dataoecd/32/18/31557724.pdf (last visited May 20, 2005) (also used extensively in the ROSC exercises).

> The *OECD Principles of Corporate Governance* were endorsed by the OECD Ministers in 1999 and have since become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide. They have advanced the corporate governance agenda and provided specific guidance for legislative and regulatory initiatives in both OECD and non-OECD countries. The Financial Stability Forum has designated the *Principles* as one of the 12 key standards for sound financial systems. The *Principles* also provide the basis for an extensive programme of co-operation between the OECD and non-OECD countries and underpin the corporate governance component of World Bank/IMF Reports on the Observance of Standards and Codes (ROSC).

Id. at 3.

> In these globalizing times, corporate law's leading question is whether one or another national corporate governance system (or component thereof) possesses relative competitive advantage . . . . Unfortunately, even as these descriptions become thicker and more cogent, answers to the bottom-line questions respecting competitive advantage have become more elusive and convergence predictions have become more qualified.[6]

Amid the thicket of discourse, speculation and experimentation on corporate governance and capital market development, a few guideposts peek through. Legal rules and legal families do matter.[7] Political structures matter.[8] History matters.[9] Legal rules can be more or less resistant to change.[10] Forces of convergence and divergence operate selectively on legal rules.[11] Legal sys-

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6. Bratton & McCahery, *supra* note 4, at 213

> ("Related questions about competitive advantage and convergence to best practice come up in domestic policy discussions in many countries. Concerns about local firms' performance in international markets turns attention to alternative governance practices identified in international comparisons: If competitive advantage lies elsewhere, then domestic practice should be reformed to follow the international leader. An extensive body of studies addresses these questions, identifying and evaluating national variations in management and financial practices, industrial organization, and corporate and securities laws.").

7. *See* Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 3 (2000).

8. RAGHURAM G. RAJAN & LUIGI ZINGALES, THE GREAT REVERSALS: THE POLITICS OF FINANCIAL DEVELOPMENT IN THE 20TH CENTURY 1–72 (Nat'l Bureau of Econ. Research, Working Paper No. 8178, 2001).

9. On the effect of the manner in which legal rules are introduced into a system, e.g., by conquest, colonization, etc., see PISTOR, *supra* note 3; DANIEL BERKOWITZ ET AL., ECONOMIC DEVELOPMENT, LEGALITY, AND THE TRANSPLANT EFFECT (Davidson Inst., U. Mich., Working Paper No. 410, Sept. 2001), *available at* http://www.bus.umich.edu/KresgeLibrary/Collections/Workingpapers/wdi/wp410.pdf (last visited May 20, 2005).

10. *See generally* LUCIAN ARYE BEBCHUK & MARK J. ROE, A THEORY OF PATH DEPENDENCE IN CORPORATE OWNERSHIP AND GOVERNANCE (Colum. Law School, Ctr. for Law and Econ. Studies, Working Paper, No. 131, 1999), *reprinted in* 52 STAN. L. REV. 127 (1999); COFFEE, COMPETITION AMONG SECURITIES MARKETS, *supra* note 4.

11. Cally Jordan, Experimentation in Capital Markets Regulation, Presentation at the International Organization of Securities Commission's (IOSCO) Seminar Training Program (Oct. 25, 2000).

tems are systems and legal concepts are not indiscriminately interchangeable components.[12]

Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny (LLSV), in an influential series of papers, turned the spotlight on the relationship of legal rules and development of financial markets, the so-called "legal origins" literature. LLSV looked to the two main legal traditions in developed economies, the Anglo-American common law tradition and the continental European "civil" or Romano-Germanic legal tradition, to conclude that the level of legal enforcement and the origin of the rules correlated to the level of development of both equity and debt markets.[13] Measures of investor protection appeared superior in common law countries and translated into more vibrant equity markets, they surmised from their findings.[14]

The implication, that common law systems are superior in fostering sophisticated financial systems, was bound to sow controversy and did not go long unchallenged:[15]

> First, it does not seem that legal or cultural impediments to financial development are as serious as one might have concluded from recent literature. Somewhat facetiously, one does not have to have the good fortune of being colonized by the British to be able to have vibrant financial markets. However, the main impediment we identify—the political structure within the country—can be as difficult to overcome as more structural impediments.[16]

Both lines of thought are significant and not necessarily incompatible; each identifies a major determinant in the functioning of financial markets, the legal rules or, more precisely, the legal family or tradition to which they belong, and the political structures which create, support, or possibly, undermine them. Le-

12. *See* Bratton & McCahery, *supra* note 4, at 215; Cally Jordan, Law Matters: Corporate Governance Legal Reforms in Asia and Their Implications for the ECA Countries, Presentation at the World Bank (Sept. 27, 2000), *available at* http://www.worldbank.org/wbi/corpgov/eastasia/core_pdfs/jordan_law matters.ppt (last visited Sept. 20, 2004).

13. *See* Bratton & McCahery, *supra* note 4.

14. *Cf*. Bratton & McCahery, *supra* note 4, at 228–30.

15. RAJAN & ZINGALES, *supra* note 8.

16. *Id.* at 7.

gal rules or, more precisely again, statutory law, are the product of and dependent upon political action.

This debate, and the related one of convergence or divergence in corporate governance systems, caught the eye of Katharina Pistor, then a legal scholar at the Max Planck Institute in Hamburg. Proponents of both a convergence theory and a divergence (or path dependency) theory "regard legal institutions as important for promoting or hindering convergence, but differ in their assessment of the propensity of a particular body of law, such as corporate law, to achieve this goal."[17] Pistor's conclusion: "a simple convergence story does not do justice to the complexity of legal change."[18]

Obviously intrigued by the complexity of legal change, Pistor has gone on to look at "legal transplants" or the "transplant effect" in corporate law and the relative effectiveness of hybridization.[19] How do legal concepts from one system fare when transplanted to another? Her conclusion here is that the manner of transplantation of a legal concept is significant. The extent to which a "foreign" legal concept has been voluntarily introduced or embraced (as opposed to imposed, for political or other reasons), is a predictor of effectiveness.[20]

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17. *See* PISTOR, *supra* note 3, at 4

> ("There is a lively debate in the corporate governance literature about these alternative patterns of institutional development and in particular about the role of law for convergence or divergence of corporate governance systems. Proponents of the divergence, or path dependence, hypothesis argue that even if the corporate law was harmonized across countries, other legal rules (tax laws, codetermination legislation etc.) and institution constraints (financial structure, existing ownership structure of firms), or simply political considerations would stand in the way of convergence. The opposite view holds that convergence is likely to take place, once the main regulatory obstacles are removed. The economic forces towards success, they suggest, are the same all over the world.").

18. *Id.* at 46.

19. BERKOWITZ ET AL., *supra* note 9.

20. *Id.* There is a rich comparative literature on legal transplants and the process of "reception" of non-indigenous legal concepts. *See* Pierre Legrand, *The Impossibility of Legal Transplants*, 4 MAASTRICHT J. EURO. & COMP. L. 111 (1997).

III. LEGAL TRANSPLANTS AND INTERNATIONAL STANDARDS: "IDEAS HAVE WINGS"[21]

The promotion of "international standards" in both capital markets and corporate governance has contributed to the proliferation of legal transplants. Dozens of international standards are being proposed (and, arguably, imposed) in financial sectors around the world.[22] The popularity of international standards is often taken as an important indicator of the inevitable, and desirable, convergence of legal rules. The pressures to conform to "international standards" can be attributed to a number of factors: heavy promotion by the international financial institutions and development agencies such as the International Monetary Fund and the World Bank, the allure of "brand name" legal solutions, and the influence of the LLSV literature (which correlates common law systems to more highly developed financial markets). The attractive simplicity of some international standards may also explain their popularity; pitched at a level of generality, they are readily accessible. A casual perusal of the *OECD Principles of Corporate Governance*[23] has created many an instant expert.

However, international standards have not been picked out of thin air. Their legal origins can be traced back to national sys-

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21.

> Ideas have wings. No legal system of significance has been able to claim freedom from foreign inspiration. Roman law "borrowed" from Greek law, Greek law from the laws of Crete and Egypt. The commercial usages of the flourishing city states of medieval Italy have laid the foundations of modern mercantile law….There is, therefore, nothing extraordinary about the adoption of "foreign" legal ideas, doctrines and even whole codes.

H. R. HAHLO & ELLISON KAHN, THE SOUTH AFRICAN LEGAL SYSTEM AND ITS BACKGROUND 484 (1973).

22. *See* Cally Jordan & Giovanni Majnoni, *Financial Regulatory Harmonization and the Globalization of Finance, in* GLOBALIZATION AND NATIONAL FINANCIAL SYSTEMS, at 259, 274–75

("[T]he proliferation of international standards and codes may exemplify the lack of coordination that often precludes 'first-best' approaches to market regulation. The establishment of the Financial Stability Forum (FSF) was specifically directed toward preventing such an outcome. As of February 2000 the FSF had identified 43 different codes and was considering 23 more for inclusion.").

23. *See supra* note 5.

tems and, in capital markets and corporate governance, predominantly common law ones. In many economies, both developed and developing, adoption of a current international standard may also entail, explicitly or implicitly, adoption of foreign legal concepts, or legal transplants, as well. Some transplants may thrive; others may be so incompatible with the underlying legal system as to never take root.

Gauging the effectiveness of these burgeoning international standards, and the extent of convergence of national legal systems to them, however is no easy matter. "[T]he empirical evidence that links indicators of efficiency and stability to the legal and regulatory framework has been based on indicators that have only an indirect relationship with the degree of compliance with international standards and codes."[24] The tenuous relationship between the adoption of international standards and the effectiveness of the legal rules embedded in them deepens the conundrum of corporate governance:

> It may be more useful for countries with very small, illiquid stock markets, to assess the conditions for establishing regional markets or for firms to access liquid foreign markets rather than to assess national compliance with IOSCO standards that reflect the experience of regulators with markets of average size and liquidity.[25]

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24. Jordan & Majnoni, *supra* note 22, at 275

> ("A serious difficulty that dogs efforts of coordination of standards and codes is the relative absence of empirical evidence demonstrating a relationship between compliance with standards and financial stability. The initial evidence that linked indicators of legal and regulatory structure to the stability of banking and financial systems is based on very aggregate indicators of structure. Only recently new empirical work has started to test the nature of relationship of specific and more detailed specification of regulatory structures with financial development and stability.").

25. *Id.* at 274 ("One of the weaknesses of the standards and codes approach and of its operational legs (the FSAP and the Report on Observance of Standards and Codes programs) is to consider small, emerging economies as Lilliputian replicas of large, industrialized ones."). As Majnoni commented in a prior version of this paper, "In keeping with literary analogies, a more appropriate perspective might be that of Saint Exupery's Petit Prince whose major concern was the effect of trees and animals imported from Earth on his tiny planet. He should have added financial institutions." (manuscript on file with the author).

The conundrum is notable in the context of the transition economies of Eastern and Central Europe: the co-existence of high quality formal legislation, a product of "an external supply of legal solutions"[26] and low levels of effectiveness.[27] Arguably, effectiveness of recent reforms in developing and transition economies has been inversely related to the degree of convergence to international standards. Why is this so?

IV. DYNAMISM AND COMPLEXITY

In the rush to international standards, a basic lesson from comparative legal scholarship has been forgotten: legal systems are both complex and dynamic.[28] "Legal systems never are. They always become."[29] Legal systems evolve over time by inventing, adapting, borrowing, and having change thrust upon them. There are often redundancies, contradictions, and fossilized concepts or practices of no current significance embodied in formal legal rules.[30] In addition, any one legal concept, in any one system, at any one time, exists and operates in a complex

26. *See* PISTOR, *supra* note 3, at 46.

27. *Id*. at 47

> ("Weaknesses in the governance structure that are noted today are often attributed to weaknesses in the law, which in turn leads to new proposals for improving statutory law. The evidence of the quality of the law on the books, however, suggests that this is at best a partial story. The level of shareholder and creditor rights protection in transition economies today is higher than in many other countries. Other factors, including the dynamic of the reform process and its impact on the development of effective institutions to enforce the new law, need to be analyzed more closely in order to understand the remarkable difference in the governance of firms despite the trend towards convergence of the law on the books.").

28. *See* Ugo Mattei, *Three Patterns of Law: Taxonomy and Change in the World's Legal Systems*, 45 AM. J. COMP. L. 5 (1997).

29. *Id.* at 14.

30. Arguably, cumulative voting, discussed *infra*, is one of the latter, having been displaced, as a practical matter, by statutory provisions permitting direct representation on the board through the action of voting groups. *See* MODEL BUS. CORP. ACT § 8.04 (1979). For example, chapter 607.0804 of the Florida Business Corporations Act (FBCA) reads, "The articles of incorporation may confer upon holders of any voting group the right to elect one or more directors who shall serve for such term and have such voting powers as are stated in the articles of incorporation." FLA. STAT. ch. 607.0804 (1999).

relationship with a myriad of other concepts.[31] Put simply, "legal systems are the result of a layered complexity that stems from the accidents of legal history and from legal transplants."[32]

The complexity and dynamism of legal systems provide yet another twist to the convergence/divergence debate. The forces of convergence and divergence operate contemporaneously, but selectively, on different kinds of legal rules. Relatively recent statutory law in highly regulated and internationalized areas, such as capital markets or banking regulation, may be very sensitive to the forces of convergence. Older, more established bodies of law, such as companies or corporate law which have their origins in the nineteenth century, are more "path dependent,"[33] more resistant to change and to the absorption of "foreign elements." The more basic the legal concept, the deeper its roots and, arguably, the more impervious to external change, to the forces of convergence, it becomes. Concepts of contract, status, and property, for example, reach back hundreds and thousands of years, and these concepts form the core of corporations law.[34]

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31. For example, in the United States, state corporate law contains provisions with respect to the use of proxies in shareholder voting. For publicly traded corporations, however, SEC regulations on proxy voting are much more significant and extensive, rendering the state provisions more or less irrelevant. Corporate law itself draws together concepts of status, contract, property, agency, trust law, etc. Directors' fiduciary duties, that cornerstone of Anglo-American corporate governance, have no one single form of expression. Fiduciary law concepts were developed by the early English courts of equity and still find their fundamental expression through the courts. In addition, various statutory formulations in U.S. corporate law (the familiar duty of care and duty of loyalty provisions, *see* MODEL BUS. CORP. ACT § 8.30 (1999)), draw on the very different concepts of negligence and trust law. The courts provide further judicial glosses on existing statutory provisions, and in many states, later enactments in reaction to judicial decisions, such as *Smith v. van Gorkom*, significantly undercut the coterminous, but earlier, general statutory duties. *See generally* Smith v. van Gorkom, 488 A.2d 858 (Del. 1985). *See, e.g.*, FLA. STAT. § 607.0831 (severely limiting directors' liability for breaches of duty.).

32. Mattei, *supra* note 28, at 13–14.

33. *See* BEBCHUK & ROE, *supra* note 10, at 154.

34. Roman law concepts have persisted over several thousand years, in both the common and civil law traditions, the common law having undergone a period of "early" reception of Roman law. "One of the effects of the Norman conquest was to throw England into closer intellectual contact with the Continent….During the twelfth and thirteenth centuries, when the foundations of

Further, legal concepts are part of complex systems and operate interdependently within their system. Capital market rules interact with corporate law rules, which themselves are grounded in notions of contract, status and property. Legal rules that, in theory, should be effective at one level, could be disabled by conflicts or incompatibility at another level. The grief which followed mass privatizations of the 1990s can be attributed to the indiscriminate mixing and matching of legal rules, a process of transplantation which resulted in dysfunctional or imbalanced feedback loops. Corporate governance systems could not support capital markets and nascent or ailing capital markets collapsed or declined. Without the disciplines of the capital markets, corporate governance systems faltered. This is not the whole story, of course, but it is a part of it.[35]

Adding to the complexity of the operation of "formal" legal rules is another complex layer, sometimes referred to as "legal sensibilities."[36] Legal sensibilities consist not only of "rules and principles which can be cast in propositional form, but also of higher order understandings, received techniques, constellations of values and shared ways of perceiving reality, which are pervasive, often subtle, and themselves deeply layered in complex and important ways."[37] A keystone to modern corporate

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the common law were being laid, Roman law…exercised great influence in England…." HAHLO & KAHN, *supra* note 21, at 504. Roman "civil law" deals primarily with concepts of status, property and contract, the backbone of the great nineteenth-century civil codes.

35. The "tunneling" and looting of corporate assets in the 1990s that occurred in Slovakia and the Czech Republic in the wake of mass privatizations have been the subject of a number of studies. *See, e.g.*, John Nellis, *Time to Rethink Privatizations*, *in* TRANSITION ECONOMIES FINANCE AND DEVELOPMENT 16 (1999). With respect to the Czech Republic, John Nellis writes that "While the most visible reasons for inadequate enterprise restructuring are weaknesses in capital and financial markets, the voucher privatization method itself—with its emphasis on speed, postponement of consideration of many aspects of the legal/institutional framework and initial atomization of ownership—is seen as the underlying cause." *Id.* at 17.

36. SCHLESINGER ET AL., COMPARATIVE LAW: CASES, TEXT, MATERIALS 288 (6th ed. 1998) (citing Clifford Geertz, *Local Knowledge: Fact and Law in Comparative Perspective*, *in* LOCAL KNOWLEDGE: FURTHER ESSAYS IN INTERPRETIVE ANTHROPOLOGY 167, 215 (1983)).

37. SCHLESINGER ET AL., *supra* note 36, at 288–89.

governance theory, the fiduciary duty, for example, is imbued with the legal sensibilities unique to its time and place.[38]

V. THE PUBLIC FACE OF LAW

In the search for answers to the conundrum of corporate governance, the focus has been primarily on what this paper calls "public legal rules": legislation, regulation, and to a much lesser degree, efforts of the judiciary. These rules constitute the public face of law. That much of the legal content of international standards has been drawn from statutory law is not surprising as statutory law is the most visible and accessible layer of a legal system. Statutory law, however, may only be the tip of the iceberg. The true significance of statutory law, too, may not be what it seems in that its role and importance in positing normative principles can vary from system to system.[39]

Drawing indicia of investor protection and good corporate governance from national corporate statutes, the easiest and most obvious sources, may also be highly misleading, depending on the role of statutory law in a system (peripheral, supplemental, fundamental). An aging body of statutory law may also be deceptive; legal systems are dynamic and statutory law inflexible, ossifying over time with concepts that no long function as they once did.[40] Moreover, corporate governance mechanisms may not be in the "corporate law" at all; they may be found in a civil code[41] or even a constitution.[42] Nonetheless, much of the debate surrounding corporate governance and the operation of capital markets has revolved around "public legal rules," i.e. legislation and, to a much lesser extent, judicial pronounce-

38. These "interaction effects impede putting our finger on one or two key features as indicative of whether technical corporate law is overall good or bad." MARK J. ROE, CORPORATE LAW'S LIMITS 32 (Colum. Law School, Ctr. for Law and Econ. Studies, Working Paper No. 186, Jan. 16, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=260582 (last visited May 20, 2005).

39. *See* Katharina Pistor & Chenggang Xu, *Incomplete Law*, 35 N.Y.U. J. INT'L L. & POL. 931 (2003).

40. *See* discussion of cumulative voting, *infra* Section VI(g).

41. For example, civil codes will often contain a title on legal persons in the first book on persons. *See infra* text accompanying note 144 discussing cumulative voting and the Illinois constitution.

42. *Id*.

ments.[43] Often, where a transplanted legal rule has been disappointingly ineffective, greater judicial action, or enforcement, has been called for.[44]

Unfortunately, this futile seesawing between demands for better legislation and greater judicial enforcement ignores the inherent complexity and dynamism of legal systems. As normative forces, even indigenous legislation and judicial enforcement demonstrate different levels of effectiveness depending on the particular legal system in which they are operating. Add transplanted legal concepts to the equation, and the possible outcomes become much more uncertain.

VI. Private Legal Rules and Legal Sensibilities

The debate over the role of legal rules in capital market development and corporate governance systems has focused on the public face of law, *ex ante* legislation and its *ex post* enforcement through the judicial process. Largely overlooked in this debate, however, has been the role of private legal rules (*ex ante* and *ex post*) and legal sensibilities. Private legal rules are established by contract (*ex ante*) and implemented and enforced (*ex post*) by means of various dispute resolution mechanisms, including arbitration, market discipline, "reputational hostage-taking,"[45] and other subtle, situational factors. Professor Frank

43. It is no coincidence that reliance on legislation and the judiciary are hallmarks of the U.S. legal system, in particular. *See infra* Section VI(g).

44. The following statement, with respect to Korean derivative law suits (an ill-advised transplant for a number of legal and cultural reasons) is typical: "The small number of derivative lawsuits brought by minority shareholders in Korea reflects the shortcomings in enforcement practices. Between 1998 and 2002 a total of 13 suits were filed by minority shareholders." Institute of International Finance, Inc., IIF Equity Advisory Group, *Corporate Governance in Korea An Investor Perspective Task Force Report*, July 2003, at 4, *available at* http://www.iif.com/data/public/KoreaTaskForceReport_Final.pdf (last visited May 20, 2005).

45. As an example of the interplay of public and private rules, Professor Frank Partnoy of the University of San Diego recently presented a paper at the Brookings Institution looking at the regulation of the derivatives markets in the United States from this perspective. *See* Frank Partnoy, *ISDA, NASD, CFMA, and SDNY: The Four Horsemen of Derivatives Regulation?*, *in* BROOKINGS-WHARTON: PAPERS ON FINANCIAL SERVICES 2–3 (Robert E. Litan & Richard Herring eds., 2002). The derivatives markets in the United States are regulated by a combination of private and public legal rules which operate *ex ante* and *ex post*, and are presented schematically in Diagram A:

Partnoy looked at the operation of *ex ante* and *ex post* public and private rules recently in the context of the U.S. derivatives markets and concluded that the "recent trend to privatize legal rules applicable to derivatives is likely to continue."[46]

The characterization of legal rules as public or private, however, does not capture the dynamism and complexity of legal rules. Private and public legal rules interact, but also ebb and flow over time. Rather than Partnoy's static four-cornered box, it is more useful to consider a continuum or spectrum along

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Diagram A: Derivatives Regulation Framework

	Private	Public
Ex Ante	Contract (ISDA)	Congress (CFMA)
Ex Post	Arbitration (NASD)	Courts (SDNY)

46. *Id*. at 36.

> First are private *ex ante* legal rules developed primarily by the International Swaps and Derivatives Association, Inc. (ISDA) for OTC derivatives (and by various exchanges and self-regulatory organizations for exchange-traded derivatives). The recent trend has been toward increased privatization of derivatives regulation, with trading volumes shifting from exchanges to OTC transactions, and this trend is likely to continue…Second are private *ex post* legal rules applied by arbitrators in disputes, particularly those of the National Association of Securities Dealers (NASD)…Arbitration has numerous drawbacks, especially uncertainty, and likely will not predominate in future adjudication of derivates disputes….Third are public *ex ante* legal rules, including securities, commodities, and banking law and regulation, but also including derivatives-specific rules. Historically, public regulation in these areas has not achieved its goals; instead public legal rules too often have generated perverse incentives related to regulatory arbitrage, regulatory licenses, and regulatory competition….Fourth are public *ex post* legal rules, including rulings by courts adjudicating derivatives disputes. Thus far, judges have shied from deciding important issues in derivatives disputes, and end-users of derivatives increasingly avoid litigation—even when losses are large—because of the high costs of discovery and motion practice.

Id. at 2–3.

which normative forces move and manifest themselves in different forms, sometimes at different times, sometimes contemporaneously. Along the continuum, in order of informality, are legal sensibilities at one end, moving through standards of behavior or conduct, private legal rules, various intermediate or hybrid forms of public/private rules,[47] through to formal legislation and judicial action on the other end. A variation on Partnoy's square would be:

Corporate Governance Rules
A Continuum

	Legal Sensibilities	Standards of Behavior	Private Rules	Quasi-Prvate/ Public Rules	Public Rules
Ex Ante	• moral obligation	• voluntary codes	• contract	• stock exchange listing rules	•legislation
Ex Post	• moral opprobrium	• reputational consequences	•arbitration	•specialized arbitration	•judicial action
Less formal◂--▸More formal					

In emerging, transitional, and developing economies, the corporate governance debate has spawned a more varied range of responses than may at first be apparent. International standards are not necessarily producing cookie-cutter reforms operating across the board in a synchronized and predictable fashion. Credit this to the ingenuity of legal practitioners of all ilks, especially in Latin America, and the inexorable process of indigenization of legal transplants.[48]

47. Intermediate or hybrid forms of rules are the product of the interaction of various kinds of normative forces.

48. For a more detailed discussion of the Latin American initiatives, see Cally Jordan & Mike Lubrano, *How Effective Are Capital Markets in Exerting Governance on Corporations?*, *in* FINANCIAL SECTOR GOVERNANCE: THE ROLES OF THE PUBLIC AND PRIVATE SECTORS 327 (Robert E. Litan et al. eds., 2002).

A. Private Legal Rules: Powerful and Pervasive

Private legal rules are powerful and pervasive. Contract is at the heart of any market and capital markets are no exception. From the central contract of purchase and sale radiates an extensive network of complex contractual relations which make the market function. The Euromarket (originally the Eurobond market) is a highly successful capital market, which until recently has been governed virtually exclusively by various forms of private legal rules.[49] It has proven remarkably resistant to the intrusion of legislation, although it may finally have been caught in the regulatory net of the European Union.[50]

On the process of indigenization of legal transplants, see Legrand, *supra* note 20, at 111.

49. *See* Frank Graaf, *Euromarket Finance: Issues of Euromarket Securities and Syndicated Eurocurrency Loans*, *in* EUROMARKET FINANCE 13–14 (1991).

50. One controversial aspect of the recently enacted EU Prospectus Directive is that it will impose greater restraints on issuances of securities in the Euromarket, which has traditionally been viewed as a "professionals only" market. *See* Council Directive 2003/71/EC, 2003 O.J. (L 345) 64, *available at* http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/l_345/l_34520031231en00640089.pdf. "Euro-securities" have benefited from significant exemptions from regulation. The definition of "euro-securities" appeared in the 1989 EU Prospectus Directive:

> 'Euro-securities' shall mean transferable securities which:
>
> –are to be underwritten and distributed by a syndicate, at least two of the members of which have their registered offices in different States, and
>
> –are offered on a significant scale in one or more States other than that of the issuer's registered office, and
>
> –may be subscribed for or initially acquired only through a credit institution or other financial institution.

Council Directive 89/298/EEC, art. 3(f), 1989 O.J. (L 124) 8–15, *available at* http://europa.eu.int/eur-lex/lex/LexUriServ/LexUriServ.do?uri=CELEX:31989L0298:EN:HTML. The definition carried over in 1993 to the EU Investment Services Directive. Council Directive 93/22/EEC, 1993 O.J. (L 141) 27–46, *available at* http://europa.eu.int/eur-lex/lex/LexUriServ/LexUriServ.do?uri=CELEX:31993L0022:EN:HTML (now repealed by Council Directive 2004/39/EC, 2004 O.J. (L 126) 1).
As explained in GOWER'S PRINCIPLES OF MODERN COMPANY LAW:

> All one need add is that the value of the business conducted on the [Euromarket] is enormous (far greater than that on any stock exchange); that when trading starts it will normally be in lots exceeding $(US) 25,000; and that there are efficiently organized clearing sys-

File: Jordan.MACRO.06.16.05.doc Created on: 6/16/2005 3:26 PM Last Printed: 6/17/2005 1:35 PM

At their origin, stock exchange listing rules, for example, are private legal rules, adhered to by contractual arrangement. This, in fact, is often the main source of their weakness as a regulatory mechanism in case of market abuse; relying on contract, exchanges ordinarily may go no further than delisting (resiliation of the contract to list) or resort to public censure (i.e.

> tems….[T]he attitude of the United Kingdom (and of other countries) has been studiously to exclude [euro-securities] from regulation—an attitude acquiesced in by the European Commission. The arguments of the [Association of International Bond Dealers] and its members which have led to this 'hands-off' treatment are (i) that the market is used by 'professionals only' and (ii) that if attempts were made to regulate it more strictly the centre of its operations would move from London to somewhere else in the European time zone (say Zurich [Switzerland is not a member of the EU]), thus depriving the United Kingdom (and, perhaps, the Community) of one of its more valuable financial assets.

GOWER'S PRINCIPLES OF MODERN COMPANY LAW 402 (6th ed. 1997). The Euro-market or, as Hal Scott calls it, the "international unregulated private placement market," has "adopted what market participants call 'international' documentation or rules, *developed by issuers, underwriters, and institutional investors*." Hal S. Scott, *Internationalization of Primary Public Securities Markets,* 63 LAW & CONTEMP. PROBS. 71, 73 (2000) (emphasis added). Even in the face of greater regulation to be imposed by the 2003 EU Prospectus Directive, the market is responding in an attempt to preserve enclaves free from regulation:

> From 1 July 05 the EU introduces a new regime which will make the disclosure and continuing obligations even for "professionals only" offerings, more onerous. In justifiable fear of a flight of business (I have been advising the Swiss Stock Exchange on the implementation of its new Eurobond listing regime) both London and [Luxembourg] are planning to establish new 'unregulated' listing regimes outside the scope of the new EU regulated regime. Interesting times in the Eurobond market!

Correspondence with Nick Eastwell, Partner, Linklaters (Feb. 21, 2005) (on file with author). Other "unregulated" markets are seeking to capitalize on the greater regulation of the traditional Euro-market. "Switzerland is also proposing to continue the old EU Eurobond regime by permitting listings in currencies other than Swiss Francs. The Channel Islands are proposing a similar market as is Singapore….All in all, it is not clear which debt market non-EU issuers will choose." Correspondence with Peter Noble, member of the International Primary Market Association (IPMA) Working Group dealing with the EU Prospectus Directive and Partner, Ogilvy Renault (Feb. 21, 2005).

invoke the power of legal sensibilities).[51] Over time, listing rules have been transformed in many cases by an overlay of public legal rules, so called "statutory backing" or subjugation to supervisory oversight, thus evolving into a form of semi- or quasi- public legal rule.

Contract, too, is at the heart of the corporate entity. Modern U.S. legal theory looks at the corporation as a "nexus of contracts."[52] In the interest of efficiency, corporate law (public legal rules) acts primarily to establish a standard form of "contract," or default rules, for the internal organization of corporations.[53] The incorporators themselves, and subsequent shareholders, may vary these rules (and often do) virtually in their entirety by contract in the private or close corporation. Close corporations, private companies, are the predominant corporate form throughout the world, in some cases comprising 99% of incorpo-

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51. *See also* Jordan & Lubrano, *supra* note 48 (discussing mandatory arbitration of shareholder disputes required of companies listing on Level 2 of the Novo Mercado, the Sao Paulo Exchange's recently created "corporate governance board").

52.

> Law and economic theorists conceptualize the corporation in terms of contract law. A corporation can be viewed as a nexus of contracts through which various claimants such as creditors, workers, shareholders, and consumers enter into agreements. Private contracts are an efficient means to lower transaction costs in the agency relationship between the shareholders and managers. One can view the articles of incorporation and the bylaws as a contract between the shareholders and the managers setting out the rules governing their relationship. This private ordering through contracts allows the parties to provide rules to maximize value and minimize costs. Under this view, corporate law should provide the basic terms of these contracts (that is, default rules), but the shareholders and the managers should be allowed to change the terms, thus providing an optimal and mutually agreeable system.

ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 115–16 (1999).

53. In the United Kingdom, and many other Commonwealth jurisdictions, contract is still the basis of the formation of a company; the memorandum of association, the contract among the founding members, is registered in order to benefit from limited liability and legal personality. The contractual basis of the company had long been a theoretical impediment to the creation of one shareholder companies; it takes two to tango and two (at least in the common law, if not in the civil law) to contract. *See* UNIF. P'SHIP ACT § 6 (1914).

rations or registrations.[54] They are primarily creatures of contract and rely on contract, in the form of by-laws and shareholder agreements in particular, for their operation.

The primacy of contract in the market also underpins the dominant regulatory approach to the capital markets (and, secondarily, corporate governance), which is the U.S. disclosure-based regime. The nature of these public, disclosure-based rules is determined by their deference to the private legal rules of the market: essentially, buyer beware. What are the characteristics of contract? It is consensual, flexible, and, optimally, both self-enforcing and *independent of political process*. Private legal rules can, thus, circumvent the impediments to financial market development thrown up by the "political structure within a country."[55]

Each characteristic of contract can vary in degree, but its consensual nature is arguably its defining characteristic. Standard form contracts, rife in the securities industry, are largely inflexible, either for the sake of predictability and convenience or due to the superior bargaining power of industry participants, but they are still consensual. By-laws or industry association rules are a variation on standard form contracts.[56] In becoming a member of the organization or company, the member agrees to abide by the rules. Contract thus forms the basis of so-called self-regulatory organizations prevalent in the Anglo-American securities industry.

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54. For example, at the time of the author's work on proposals for modernized companies legislation in Hong Kong, nearly 99% of companies registered in Hong Kong were private companies. "Of the 483,181 companies registered in Hong Kong as of 31 December 1997, 477,140 are private companies." CALLY JORDAN, REVIEW OF THE HONG KONG COMPANIES ORDINANCE – CONSULTANCY REPORT 30 (1997). For information on the German equivalent of the close corporation or private company, see also SCHLESINGER ET AL., *supra* note 36, at 923 ("In Germany and in most countries that have followed its model, the limited liability company (GmbH) is enormously popular. By 1991, Germany had about 465,660 limited liability companies (GmbHs) as opposed to only 2,800 stock corporations (AGs)….").

55. *See generally* RAJAN & ZINGALES, *supra* note 8.

56. The derivation of the word "by-law" is interesting in this respect. It is believed to come from the Old Norse language "byrlaw": a local custom or law of a manor or district whereby disputes over boundaries and trespass were settled *without recourse to the public courts of law* or a regulation or ordinance agreed to *by consent* in baronial court. NEW SHORTER OXFORD ENGLISH DICTIONARY 310–11 (2d ed. 1993).

There are, however, several drawbacks to private legal rules. In the absence of agreement, there is impasse. Then there must be recourse to public law, which is rigid, prescriptive, circumscribed, and, in the case of legislation, at least, subject to the vagaries of political process.[57] Nevertheless, in certain circumstances and certain legal systems, public legal rules are more effective than private legal rules.

B. Private Legal Rules are Important

The debate over regulation of capital markets and governance of corporations since the early 1990s has primarily been an Anglo-American one.[58] Not surprisingly, many governance mechanisms that have recently proliferated find their origins in Anglo-American law and practice.[59] Although the debate surged into public prominence ten to fifteen years ago (for a variety of reasons),[60] it has been the daily bread of lawyers and accountants for a hundred and fifty years or more.

Over time, fairly standardized private legal rules developed in the context of negotiated partnership contracts, shareholder agreements, and private company by-laws. These private legal

57. The judiciary and judicial action may not be immune to the vagaries of political process either. Despite the admirable independence of the U.S. judiciary, the appointment process is highly politicized.

58. The debate has, in more recent years, been picked up with vigor in Asia and continental Europe, where the issues and concepts are being recast in a different corporate and legal context. See, for example, the efforts of the European Corporate Governance Institute (ECGI), *at* http://www.ecgi.org, and the Asian Corporate Governance Association (ACGA), *at* http://www.acga-asia.org.

59. For example, voluntary codes, cumulative voting and class actions. *See* discussion *infra* Sections VI(e), (f), (g).

60. Some of the reasons include U.K. privatizations of the 1980s creating a vocal shareholder base wielding political power, the tabloid scandals of the Maxwell affair, outrageous U.S. executive compensation, the glamorization of Wall Street, etc. The London Stock Exchange and the UK Society of Accountants worked together to look at the issues, primarily involving financial accountability of the board of directors. Their report, the "Cadbury Report," proved extraordinarily influential in shaping the ensuing world-wide corporate governance debates. *See* Committee on the Financial Aspects of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* (1992), *available at* http://www.blindtiger.co.uk/IIA/uploads/2c9103-ea9f7e9fbe--7e3a/Cadbury.pdf (last visited May 20, 2005) [hereinafter Cadbury Report].

rules were designed to balance the ongoing economic interests of participants and, if necessary, provide egress from the enterprise and dispute resolution without recourse to the courts. In commercial matters, the courts would be a last resort.[61]

In the United States, possibly for reasons discussed below, some of these contractual governance mechanisms metamorphosed into various kinds of public legal rules, particularly in the case of private or close corporations. Among these rules were tag-along rights in case of change of control, puts and calls to provide an exit, valuation mechanisms to determine economic interests, disinterested voting techniques to deal with conflicts of interest, buy-out or appraisal mechanisms triggered by certain events, and arbitration and non-judicial dispute resolution.[62] Some of these contractual governance mechanisms were adapted and crossed over to the realm of public corporations. Their outlines, for example, are readily discernible in the Williams Act,[63] which is the source of U.S. tender offer rules.

These contractual governance mechanisms are not exclusive to the United States. For example, these private legal rules figure prominently, in different forms, in recent Latin American initiatives, such as the so-called corporate governance board of the Sao Paulo Stock Exchange.[64] Private legal rules, contract, are important in and of themselves but are also important in two other respects. First, private legal rules generate market-tested solutions that can, over time, provide the basis for public legal rules of greater general applicability, as has been the experience in the United States. Secondly, as Professor Partnoy observes, over time, public legal rules may migrate back to the private sector in search of a more effective form of expression.

61. Litigation can be a devastatingly slow and expensive process that can destroy a business or commercial relationship.

62. These mechanisms, for the most part, are now statutory in nature in state corporate law following the MBCA. *See, e.g.*, DEL. CODE ANN. tit. 8 §§ 214 (cumulative voting), 262 (appraisal rights) (2001).

63. Williams Act of 1968, 15 U.S.C. § 78(d)–(f) (2000).

64. For a detailed discussion, see Jordan & Lubrano, *supra* note 48.

C. Legal Traditions: Different Balances in Terms of the Effectiveness of Private and Public Legal Rules

Even within the common law tradition, there are significant differences between English (now Commonwealth) and U.S. traditions. The U.S. common law tradition branched off over two hundred years ago at the time of the American Revolution[65] and, in some interesting respects, has greater affinities with the continental European tradition than with the English common law: "Law in the United States is generally seen as adhering to a common law 'family,' but today this is far from obvious."[66] This fundamental misunderstanding of the U.S. legal system has distorted an otherwise thought-provoking analysis of the relationship of legal origins and development of financial systems.[67] "The particular genius of US law…has been its constructive combination of elements of *both* civil and common law."[68]

The U.S. and English traditions do share a common characteristic, although it may find a different manner of expression in each system: heavy reliance on *ex post* public legal rules through enforcement in the courts. As every common law student learns in the first week of law school, there is no right without a [judicial] remedy.[69] This remedial legacy endows pro-

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65. *See* CONSTITUTIONAL LAW 2–5 (Geoffrey R. Stone et al. ed., 1996).

66. H. PATRICK GLENN, LEGAL TRADITIONS OF THE WORLD 248, 251 (2d ed. 2004).

> In many respects US law represents a deliberate rejection of common law principles, with preference being given to more affirmative ideas clearly derived from civil law. These were not somehow reinvented in the United States but taken over directly from civilian sources in a massive process of change in adherence to legal information in the nineteenth century.

Id. at 248.

67. *See supra* note 2.

68. GLENN, *supra* note 66, at 251 (emphasis added) ("Grant Gilmore observed that U.S. lawyers were 'convinced eighteenth-century rationalists,' in the French tradition, while at the same time, U.S. law would represent 'the arrogation of unlimited power by the judges.'").

69. *Id*. at 228

> ("'Where there is no remedy there is no wrong [quoting Maitland].' So the common law came to be composed of a series of procedural routes (usually referred to as remedies) to get before a jury and state one's case….In contemporary language the common law was there-

cedural elements of the law and the judicial system in common law traditions with great importance. This centrality of procedural law and the judicial system is not necessarily recognized or shared in other legal traditions.[70]

In the English common law, the importance of judicial action, case law, and *ex post* public legal rules continue to dominate statutory, or written, law, the *ex ante* public legal rules. The English common law system demonstrates to this day a surprising aversion to law as legislation, to *ex ante* public legal rules.[71]

> fore a law of procedure; whatever substantive law existed was hidden by it, 'secreted' in its 'interstices,' in the language of Maine.").

70. *Id*. ("The procedure was, and is, unique in the world and may be today the most distinctive feature of the common law.").

71. In the company law area, for example, both the U.K. and Hong Kong (while still British territory) demonstrated an active resistance to creating statutory formulations of directors' duties and the derivative action, preferring to rely on a tangled mass of case law dating back to the 1840s. *See* JORDAN *supra* note 54, at 122

> ("Until recently, it seemed that the United Kingdom was moving in the direction of statutory standards [of directors' duties]. According to the U.K. Department of Trade and Industry working group on Directors Duties, there was 'support emerging for the codification of directors' duties similar to the approach adopted in other Commonwealth countries. The DTI favours a reduced Part X coupled with a 'statement' of directors' duties' (Great Britain, Department of Trade and Industry, *DTI's Programme for the Reform of Company Law – Progress Report* (London: Department of Trade and Industry, 11 June 1996)). A subsequent Progress Report (October 1996) indicates, however, that such an initiative has been again derailed. The U.K. Jenkins Committee, in 1962, considered that a general statement of the basic principles underlying the fiduciary relationship of directors towards their companies would be useful to directors and others concerned with company management. The Second Report in Hong Kong in 1973 agreed and so recommended. The SCCLR has also so recommended. Efforts were made to develop a statutory formulation of directors' fiduciary duties in Hong Kong, the most recent being the Companies (Amendment) Bill 1991. The Bill was not enacted due to objections expressed in particular by the Law Society. The Law Society was of the view (among other things) that any attempt to draft a statutory formulation of directors' fiduciary duties would be incomplete and that it was better to continue with the present system where a director should consult his professional advisors whenever a question involving his fiduciary duties to the company arose. When the Bill was withdrawn, the Government encouraged the private sector to draft guidelines to better inform directors of their duties. In 1995 the Hong Kong branch of the Institute of Directors published

Large and complex swathes of English law are not found in written legislation. Trust law, from which is derived the concept of "fiduciary duties" so important to corporate governance in the Anglo-American system, is a prime example; its fundamental principles remain judge-made, with *ex post* public legal rules as their source.

In some instances, there are not even judge-made rules to look to in England. For example, England has no written constitution; rather, in its place are "parliamentary conventions" which developed over long periods of time and operate on a consensual basis.[72] These parliamentary conventions are imbued with "legal sensibilities," but not less effective for that reason. Fiduciary duty, too, draws much of its residual power from the influences of legal sensibilities, leftovers from an earlier time when they enjoyed greater formal normative force.[73] The con-

> *Guidelines for Directors* which was, in part, intended to be responsive to the need for some private sector guidelines. Of special interest in this area is the SEHK Listing Rules' formulation of directors' duties, which demonstrates its affinity to modern statutory formulations.").

A form of statutory derivative action was also resisted in Hong Kong (although there were other considerations at work as well). In recommending the creation of such a statutory provision, the *Consultancy Report* stated that

> On balance, in the interests of certainty, simplicity and conformity with other Commonwealth jurisdictions, a statutory derivative action is desirable. The prophylactic effect of such an action is salutary. It also appears to be the only way in which to lay to rest the unruly ghost of Foss v. Harbottle [1843], which it must be remembered, was decided before the advent of even 19th century statutory company law. The U.K. case law on the rule in Foss v. Harbottle has taken some unfortunate turns in recent years creating unnecessary hurdles for shareholders in international disputes being played out in the United Kingdom. Characterised as a procedural rule under principles of U.K. private international law, the intricacies of the rule have been superimposed on shareholders of companies incorporated in other jurisdictions which provide more modern remedies. There is some evidence that this line of U.K. case law would also be applied in Hong Kong.

Id. at 152.

72. What a way to run a country some might say. For a discussion of parliamentary conventions, see Resolution to Amend the Constitution, [1981] S.C.R. 753 (Can.) at 772.

73. The fiduciary duty has its origins in medieval ecclesiastic courts in England; at the time, canon, or ecclesiastical, law and the ecclesiastic courts were a very real and present source of normative propositions. *See* Mary Szto,

cept of fiduciary duty, so fundamental to Anglo-American corporate governance, does not transplant well, if at all, because of its dependence on specific court structures and cultural and historic "legal sensibilities."[74]

The U.S. legal tradition shows no such reticence in the use of legislation, *ex ante* public legal rules. In this respect, proclivities of the U.S. legal tradition are more in line with those of continental Europe.[75] It is no accident that the United States has a Uniform Commercial Code,[76] Bankruptcy Code, and any number of other state and federal codes.[77] The formative decades of the early Republic were very much influenced by French legal thought and institutions.[78]

As for continental European legal traditions, which serve as the basis for the legal systems of much of the world outside the

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Limited Liability Company Morality: Fiduciary Duties in Historical Context, 23 QUINNIPIAC L. REV. 61, 61 (2004).

74. The Chinese Companies Law of 1993 crudely 'codified' certain aspects of the fiduciary duty: managers are prohibited from accepting bribes and from depositing company funds in their personal bank accounts, for example. *See* Company Law of the People's Republic of China, arts. 211, 214 (Adopted at the Fifth Meeting of the Standing Committee of the Eighth National People's Congress, 1993), *available at* http://www.cclaw.net/download/companylaw.asp (last visited May 20, 2005). *See also id*. art. 59, para. 2 ("A directors [sic], supervisor, or the general manager may not abuse their authorities by accepting bribes or generating other illegal income, and may not convert company property."); art. 60, para. 2. ("A director or the general manager may not deposit company assets into an account in his own name or in any other individual's name."); art. 61 ("A director or the general manager may not engage in the same business as the company in which he serves as a director or the general manager either for his own account or for any other person's account, or engage in any activity detrimental to company interests. If a director or the general manager engages in any of the above mentioned business or activity, any income so derived shall be turned over to the company."). Note that the latter part of art. 61 is a classic statement of the fiduciary law remedy for breach of the prohibition on acting in a conflict of interest.

75. *See generally* GLENN, *supra* note 66 (discussing global legal traditions).

76. It is a sometimes overlooked fact that the Uniform Commercial Code in the United States was inspired directly by the German Commercial Code. "The principal architect of the Code, the late Professor Karl N. Llewellyn, had spent considerable time in Germany, and there can be no doubt that some of the Code's important features were inspired by his study of German law." SCHLESINGER ET AL., *supra* note 36, at 20–21.

77. For more on the history of the Bankruptcy Code, see DAVID A. SKEEL, DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA (2001).

78. *See generally* GLENN, *supra* note 66.

Commonwealth, their most important defining characteristic may be the importance of "written law," *ex ante* public legal rules, particularly as embodied in the great nineteenth-century civil and commercial codes. These countries are *pays du droit ecrit*, which translates as "countries of written law."[79] If in the common law world there is no right (or, more correctly, no wrong) without a remedy, then in the continental European tradition there is no right without a written law. In the continental European context, judicial pronouncements are of relatively (and the stress here is on relatively) little importance.[80]

A related characteristic of continental European law, virtually unknown in the United Kingdom, is the hierarchy of laws: in decreasing order, constitution, code, statute, decree, and regulation. As in a game of cards, a civil or commercial code provision will always trump a statutory law, which is considered "specialized" or subordinate legislation, subject to the overarching principles of the code. Any subsequent legal transplant which takes the form of statutory enactment will be subservient to even pre-existing civil code provisions which may date back a century or more.

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79. "Pays du droit ecrit" being a term identifying a certain geographic area (originally, that region of France south of the Loire) and a legal tradition (deriving from a continuation of Roman law somewhat modified by Germanic custom).

> At the time of the withdrawal of the Romans [from the south of what is now modern France], Roman provincials (who in accordance with the personality principle were governed by Roman law) by far outnumbered Germanic settlers. The result was that Roman law…continued to be the law of the land, modified to some extent by Germanic custom.

HAHLO & KAHN, *supra* note 21, at 509.

80. As with all such generalizations, the interest lies in the exceptions. However, see GLENN, *supra* note 66, at 145–46

> ("There are problems…with the notion of judicial independence in the civilian tradition. Given the *ancien régime*, nobody wants a '*gouvernement des juges*', so the primacy of the codes, and legislation in general, is reinforced by ongoing skepticism towards, and even surveillance of (through control of the career structure) the civilian judiciary.").

D. Effective Rules: Form and Substance

The preceding discussion has not been idle dalliance in the fascinating, but irrelevant, backwaters of comparative law. The effectiveness of a governance mechanism in a particular legal system will relate to the form it takes. To the extent that the LLSV literature recognized that legal families do matter, it provided a valuable insight.[81] Pistor, too, is correct in her observation that the manner in which a legal concept is introduced or transplanted matters.[82] Equally, the form which a rule takes matters.[83] Some of the otherwise "inexplicable" consequences, such as the failures of the waves of capital markets and corporate governance initiatives, can be traced to a failure to recognize the importance of these observations.

Some of the most popular governance mechanisms, such as voluntary codes, cumulative voting and class actions, may not survive transplantation to another legal system because they are an inappropriate form of rule. Others may be fundamentally incompatible with the underlying legal structure. The concept of fiduciary duty, for example, is notable for its absence in other legal systems despite its importance as a mechanism for corporate governance in the Anglo-American tradition. Fiduciary duty is a concept too complex, exotic, and imbued with legal sensibilities to take root easily elsewhere.[84]

E. Voluntary Codes of Corporate Governance

Voluntary codes of corporate governance have probably been the most popular governance mechanism of the 1990s and have proliferated, irrespective of legal tradition, corporate ownership patterns or level of development of the capital market. These codes trace their immediate origins to the 1992 Cadbury Report in the United Kingdom.[85] None would question the extraordi-

81. As noted above, the LLSV "legal origins" literature fundamentally misunderstood the nature of these legal families.

82. *See* BERKOWITZ ET AL., *supra* note 9.

83. *See* Jordan & Lubrano, *supra* note 48.

84. Again, the exceptions to this generalization are of interest. *See supra* note 74 and accompanying text for the examples of codification of fiduciary duties in Chinese companies law and the discussion *infra* note 94 and accompanying text of the introduction of trust law principles in the Quebec and Mexican civil codes.

85. *See* Cadbury Report, *supra* note 60.

nary influence of the Cadbury Report in spawning a world-wide interest in corporate governance and the mechanisms to promote it. In the United Kingdom, its country of origin, the current manifestation of the Cadbury Report and its subsequent recommendations is the Combined Code."[86] The most significant feature of the Combined Code is that, contrary to the implication in its title, it is not written law but, rather, is a "voluntary" code. In the continental European tradition, a "voluntary" code is an oxymoron. A "code," in the European tradition, is written law of high normative force.[87]

So, what is the Combined Code, if not legislation? It is a code in another sense in that it is "a set of rules on any subject*, esp*., the prevalent morality of a society or class; an individual's standard of moral behaviour."[88] The Combined Code is a code of conduct and ethics informed by legal sensibilities. The Combined Code is not even a form of private legal rule; rather, it is no more than a set of suggested guidelines. Absent is the binding force of contract that a set of industry association rules might possess by virtue of contractual membership obligations.

The questions then become, first, how effective the Combined Code can be and, second, why this choice of form is appropriate? To begin, the Combined Code can be reasonably effective in the United Kingdom, all other things being equal.[89] Remember that the United Kingdom relies on unwritten parliamentary conventions in lieu of a written constitution and has a respectable, if now frayed, tradition of the use of moral suasion as a regulatory technique.[90] The Combined Code is not the only instance of a "voluntary" code either in the United Kingdom; the "City Code"

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86. Committee on Corporate Governance, Combined Code, Principles of Good Governance and Code of Best Practice (1998) (Eng.), *available at* http://www.fsa.gov.uk/pubs/ukla/lr_comcode3.pdf#search='Committee%20on%20Corporate%20Governance,%20â€œThe%20Combined%20Codeâ€%20London,%201998' (last visited May 20, 2005).

87. The Shorter Oxford English Dictionary defines "code" as: "A written body of laws so arranged as to avoid inconsistency and overlap." SHORTER OXFORD ENGLISH DICTIONARY 441 (5th ed. 2002).

88. *Id.*

89. There have been criticisms of its effectiveness, but all things are relative.

90. Tea with the Governor of the Bank of England, for example, prior to recent regulatory reforms.

or Takeover Code[91] was not written legislation, it too was a "voluntary" code. The legal sensibilities in this particular area have been vital enough in the United Kingdom, at least until the very recent past,[92] to support the effectiveness of voluntary codes as a normative proposition.

As to the second question concerning choice of form, the answer is more elusive. It is not as though the United Kingdom emulates existing models when embracing a voluntary code. Several of the substantive recommendations of the Cadbury Report, such as the use of audit, remuneration and nomination committees are taken directly from the listing rules of the New York Stock Exchange.[93] These rules we would characterize as semi- or quasi- public rules because their binding nature derives from contract but they are also subject to regulatory oversight of Securities and Exchange Commission, a public agency. The use of audit committees by New York Stock Exchange-listed companies was not a pious wish; it was a mandatory requirement. To trace the origins of the audit committee recommendation even a little further back, it is found in legislative

91. Panel on Takeovers and Mergers, City Code on Takeovers and Mergers and the Rules Governing Substantial Acquisitions of Shares (2002) (Eng.), *available at* http://www.thetakeoverpanel.org.uk/ (last visited Mar. 27, 2005).

92. The UK Financial Services Authority (FSA) was created under the Financial Services and Markets Act, 2000, c. 8 (Eng.) and assumed its powers and responsibilities on December 1, 2001. It is an independent non-governmental regulator, created by statute and exercising statutory powers. The FSA is a "unitary" regulator, directly responsible for banking, insurance and the investment business. In its own words, the "FSA takes a radically different approach to regulation from that of its predecessors." FINANCIAL SERVICES AUTHORITY, AN INTRODUCTION TO THE FINANCIAL SERVICES AUTHORITY 7 (2001), *available at* http://www.fsa.gov.uk/pubs/other/fsa_intro.pdf (last visited May 20, 2005). The internationalization of capital markets and the consequent pressures exerted from both sides of the Atlantic are likely a prime contributor to the decision by the UK authorities to radically change their approach to financial services regulation.

93. For example, the "audit committee" was introduced by the NYSE in 1978. *See* Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, and Other Ills*, 29 J. CORP. L. 267, 336 (2004). For a description of the audit committee's duties, see Constitution of the New York Stock Exchange, art. IV, § 12(3), *available at* http://rules.nyse.com/nysetools/Exchangeviewer.asp?SelectedNode=chp_1_1_4&manual=/nyse/constitution/constitution/.

form, as an *ex ante* public legal rule, even earlier.[94] So, there is one rule with three different, related, manifestations, which begs the question of their relative effectiveness.

The question remains, however, of the efficacy and wisdom of a voluntary code. A number of virtues can be cited, among them flexibility, responsiveness, sensitivity to industry specific concerns and considerations, the usual virtues of private legal rules. Underlying these rationales, though, the peculiar British aversion to written legislation, *ex ante* public legal rules, also shines through. There may also be even subtler forces at work in influencing the form these rules have taken in the United Kingdom.

For example, the Cadbury Report in 1992 focused on the board of directors, its composition and responsibilities.[95] The directors of English companies, like their U.S. counterparts, are subject to fiduciary duties derived from very medieval concepts of trust law. Early nineteenth-century English (and U.S.)[96] business enterprises were often organized as trust vehicles with the director roles being assumed by "real" trustees. Trustees are subject to strict fiduciary duties of impartiality and accountability which, due to a quirk of medieval history, were enforced by a separate *ecclesiastic* court system known as Courts of Equity.[97] Fiduciary duties are triggered whenever there is a separation of ownership from management of property[98] and, thus, easily carried over to the obligations of company and cor-

94. In 1975, the new Canada Business Corporations Act had introduced a provision making audit committees mandatory for federal publicly traded companies. Canada Business Corporations Act, R.S.C., ch. 44 § 171 (1975). The interesting twist here is that, although inspired in many respects by the U.S. Model Business Corporations Act, the Canadian legislation was also subject to the beneficent influences of the Quebec Civil Code (itself at that time based largely on the French Napoleonic Code), in terms of legislative approach and drafting techniques, and with its continental European bias in favor of written law, *ex ante* public legal rules.

95. *See generally* Allison Dabbs Garrett, *Themes and Variations: The Convergence of Corporate Governance Practices in Major World Markets*, 32 DENV. J. INT'L L. & POL'Y 147 (2004) (discussing global corporate governance practices).

96. *See* Gashwiler v. Willis, 33 Cal. 11 (1867).

97. *See* DOUGLAS LAYCOCK, MODERN AMERICAN REMEDIES: CASES AND MATERIALS 6–8 (3rd ed. 2002).

98. *See* FAMILY PROPERTY LAW: CASES AND MATERIALS ON WILLS, TRUSTS, AND FUTURE INTERESTS 1299–1364 (Lawrence W. Waggoner et al. eds., 2002).

porate directors. Enforced by the Courts of Equity, fiduciary duties were suffused with moral righteousness and legal sensibilities. A voluntary code for directors' duties (in the Oxford English Dictionary sense of a vehicle establishing "a standard of moral behaviour"),[99] such as the Combined Code, is very much in keeping with the constructs of this tradition.

The specificity to the United Kingdom of the choice of a voluntary code of corporate governance should be obvious by now. The question then becomes how effective such voluntary codes could be elsewhere. Would they transplant well, even if not imposed through conquest or colonization?[100] Could they be transplanted at all in continental European law systems or the complex hybrid legal systems of Asia? For example, it would be hard to imagine the French (or Americans, for that matter) jettisoning their beloved constitution for a variant of English parliamentary convention.[101] Further, why have voluntary codes of corporate governance been so immensely popular?

F. Voluntary Codes and International Capital Markets

Here is where the capital markets may, ironically, be producing a perverse effect on corporate governance initiatives. International capital markets have been so dominated in recent years by Anglo-American law and practices that the spillover into other law and practice, regardless of legal tradition, has

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99. SHORTER OXFORD ENGLISH DICTIONARY 441 (5th ed. 2002).

100. *See* BERKOWITZ ET AL., *supra* note 9.

101. The sorry saga of the recent Russian code of corporate governance demonstrates the muddle which follows an attempt to integrate a voluntary code into a continental European system unable to recognize the concept. *See* Jordan & Lubrano, *supra* note 48, at 349

> ("Russia's new code of corporate governance had a more dirigiste provenance than Mexico's….A committee selected by the FCSM [Russian Federal Commission on Securities Markets] was assigned the task of preparing a final code within a year….As initially conceived, the code was to be a (quite lengthy) compendium of existing law, regulation, and FCSM interpretation, as well as 'recommended' practices not necessarily grounded in the existing legal and regulatory framework. An early draft of some of the code's chapters indicated that the document would not likely be very clear about which of its provisions were restatements of existing law, which represented FCSM interpretation of the existing framework, and which were to be regarded as merely hortatory.").

been inevitable, if uneven. Some spillover may be ineffective because the mechanisms introduced are incompatible with or unknown to the underlying legal system, fiduciary duties for example. In other cases, the transplanted legal concepts may contradict civil or commercial code provisions. The newly-introduced elements may then be simply trumped, rendered ineffective, by older civil code (or even constitutional) provisions which are higher in the legal hierarchy.

Other legal mechanisms, voluntary codes possibly among them, may be detrimental to developing better corporate governance. Deliberately introducing an ineffective, but internationally recognized, corporate governance delivery mechanism such as a voluntary code may cause political interests to divert attention from approaches which could be more effective, but also more disruptive to the cozy corporate and political status quo.[102] Such strategies are not restricted to developing economies. The German corporate governance code, a voluntary code introduced in 2002, provides an example. Justice Minister Herta Daubler-Gmelin "argued that while the code contained no sanctions for non-compliance, 'the capital market will provide very effective sanctions' for those that chose to ignore it."[103] The Financial Times editorial writer was skeptical at the time of introduction of the voluntary code, stating flatly that it would do "little to nudge German corporate governance towards a more investor-friendly model."[104] This skepticism has been largely vindicated by subsequent events; three years later the voluntary code is considered "a failure" and plans are afoot to replace it with written legislation.[105]

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102. *See* RAJAN & ZINGALES, *supra* note 8.

103. Sven Clausen & Hugh Williamson, *Berlin Announces Voluntary Business Code*, FIN. TIMES, Feb. 27, 2002, at 7.

104. *German Takeover*, FIN. TIMES, Feb. 27, 2002, at 12
("Common rules for corporate takeovers have become a test for Europe's capacity to reform itself. Thanks to the conservatism of German business and the refusal of the Berlin government to look beyond narrow political interests, is one that Europe is likely to fail. Despite the eye-catching call for greater disclosure of executive pay, Germany's new voluntary code, published yesterday, does little to nudge German corporate governance towards a more investor-friendly model.").

105. *See* Patrick Jenkins & Hugh Williamson, *Executives Under Pressure on Pay*, FIN. TIMES, Jan. 19, 2005, at 16

On the other hand, as ineffective as such a mechanism may be domestically in directly raising standards of corporate governance, it may have a signaling effect in the international markets. To the extent corporations participate in the international capital markets (perhaps only a tiny fraction of a country's corporate universe), other more effective corporate governance mechanisms would be engaged through foreign listing rules, compliance with U.S. securities laws and regulations, *inter alia*. Where there is little interest in international capital markets, however, there may be little interest in triggering the signaling effect of introduction of a domestically inappropriate, but internationally recognized, corporate governance mechanism.[106]

G. Cumulative Voting and Class Actions

Like voluntary codes, cumulative voting mechanisms and class actions have also popped up around the world.[107] Early LLSV literature, which identified the presence of both of these

("A group of 21 Social Democrat members of the German parliament will today table a draft bill to force company executives to disclose details of their remuneration and bring to an end a deep-rooted culture of secrecy in the country's boardrooms. The bill, drafted in consultation with corporate governance expert Theodor Baums, comes in response to what the legislators see as the failure of a three-year-old voluntary code to prompt disclosure.").

106. Tunisia, for example, with a very "pure" French civil law tradition, has recently introduced new corporate law designed to improve various aspects of governance, but has little interest in a voluntary code of good corporate governance (although there is some greater interest in judicially oriented statutory shareholder remedies). *See, e.g.*, Code des sociétés commerciales, Loi no. 2000-93 du 3 novembre 2000, art. 477. As the head of the Centre des etudes juridiques et judiciaries explained to the author in an interview in Tunis in February 2001, the concept of a voluntary code of corporate governance is inconsistent with the Tunisian legal tradition which prefers structural adjustments to the corporate law, *ex ante* public legal rules. To the extent there is little interest in participating in international capital markets by Tunisian corporations (non-domestic activity is more likely to be focused on France and Italy), there is little need to send a signal to the international capital markets.

107. *See, e.g.*, Sang-Woo Nam & Il Chong Nam, *Corporate Governance in Asia: Recent Evidence from Indonesia, Republic of Korea, Thailand and Malaysia*, Asian Development Bank Institute (2004), *available at* http://www.adbi.org/files/2003.11.10.paper.recent.evidence.pdf#search='SangWoo%20Nam,%20Il%20Chong%20Nam' (last updated May 20, 2005).

so called "anti-director" mechanisms as indicative of the presence of effective corporate governance regimes, has no doubt been influential in this regard.[108] Statutory cumulative voting and class actions originated in the United States and are procedural mechanisms (note their procedural nature) designed to enhance minority shareholder representation at the board level, on the one hand, and promote management accountability through judicial recourse, on the other.

Again, the primary virtue of such governance mechanisms is their signaling effect to international capital markets. U.S institutional investors recognize the signal, which means the domestic market has become aware of and taken up the corporate governance debate.[109] Cumulative voting and class actions are like little flags attracting the momentary attention of the international capital markets. As effective mechanisms of promoting better governance in the corporate sector domestically, however, they will likely prove disappointing. First of all, cumulative voting in particular, does little to promote corporate governance even in the United States. Secondly, as transplants, both mechanisms may prove to be the wrong form of legal rule for most of the legal systems in which they find themselves. In addition, these mechanisms may have been transplanted by a method (i.e. imposed rather than voluntarily adopted) likely to result in their failure to perform as expected.[110]

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108. *See supra* note 2.

109. The author participated in a "road show" meeting in New York City in 2002 where the Sao Paulo Stock Exchange (BOVESPA) was making a presentation to major U.S. institutional investors on its new corporate governance board, the Novo Mercado. One institutional investor inquired as to whether Brazil had cumulative voting provisions in its corporate law (it didn't). What the investor failed to realize, and what the BOVESPA failed to mention, was that pending legislation in Brazil was to provide a mechanism for direct board representation by minority shareholders holding a certain percentage of shares, in fact, a much better, substantive right than a cumulative voting mechanism. For a more detailed description of the Novo Mercado, see Jordan & Lubrano, *supra* note 48, at 341.

110. Adoption of cumulative voting and class actions has often been highly recommended or otherwise "imposed" by international financial institutions. *See*, *e.g*., Joongi Kim, *Recent Amendments to the Korean Commercial Code and their Effects on International Competition,* 21 U. PA. J. INT'L ECON. L. 273, 328 (2000) ("Furthermore, Korea is facing considerable peer pressure from international organizations such as the Organization for Economic Co-operation and Development ('OECD') to modify its corporate regulation to reflect newly

The introduction of cumulative voting and class actions in Korea provides an example of such failure. The Korean legal system, at its most formal level, has been strongly influenced historically by German models (originally via Japan) and, for that reason, would demonstrate a predilection for *ex ante* public legal rules, written law.[111] As in the other legal systems with which Korea shares its heritage, procedural rules and reliance on *ex post* public legal rules, judicial recourse, are limited in their effectiveness. For example, in Korea, the "Commercial Code provision governing derivative actions [another U.S. procedural transplant relying on judicial action] for practical purposes has been dead paper."[112]

An additional complication in the case of Korean corporate law has been the ongoing dysfunctionalities associated with earlier transplants from U.S. law:

> Most of the faults in Korean corporations can be traced to the failure of the corporate regulatory framework. In essence, the management structure established to oversee business firms did not function as expected. Corporate actors, such as shareholders, the board of directors, representative directors, and auditors, did not fulfill their respective statutory duties. One expert describes the anomalous situation whereby Korean boards would monitor themselves as being functionally in between the dual-board system or two-tier system of Germany, and the single board or one-tier system of the United States.[113]

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emerging international standards."). According to Pistor, the degree of imposition of a transplanted legal rule correlates to the likelihood of failure of the rule. PISTOR, *supra* note 3, at 2. Current corporate governance endeavors eerily hark back to similar efforts at imposition of foreign transplants in the post WW II era in Japan. *See* Kim, *supra*, at 277 n.13 (quoting Thomas I. Blakemore & Makoto Yazawa, *Japanese Commercial Code Revisions: Concerning Corporations*, 2 AM. J. COMP. L. 12, 15–16 (1953)).

111. "Although Korea hails from the German civil law tradition, it is not a legal requirement that employees can elect a board member of the company." Hasung Jang & Joongi Kim, *Korea Country Paper: The Role of Boards and Stakeholders in Corporate Governance*, THE THIRD OECD ASIAN ROUNDTABLE ON CORPORATE GOVERNANCE, Singapore, Apr. 4–6, 2001. Like Japan, Korea demonstrates significant U.S. influences in its statutory law, and some of its financial institutions.

112. Chul-Song Lee, *So-soo-joo-joo-gwon-ui shil-hyo-sung gum-to [Review of the Effectiveness of Minority Shareholder Rights]*, 35 SANG-JANG-HYUP 7, 7 (1997), *cited in* Kim, *supra* note 110, at 282 n.34.

113. Kim, *supra* note 110, at 277–78.

The legacy of ill-conceived, poorly indigenized, legal transplants persisted over decades, the structure finally cracking under the pressures of the 1997 Asian financial crisis, according to Joongi Kim. It is thus terribly ironic that solutions proposed in the wake of the crisis, such as cumulative voting, are similarly ill-conceived transplants.

Cumulative voting is a curious rule. It smacks of private legal rules, election procedures at, say, the bridge club or the country club. In the United States, its "application to shareholder voting is a path-dependent historical oddity."[114] It is a procedural voting mechanism, and a cumbersome one at that,[115] under which minority shareholders have a chance (but only a chance) for some degree of representation on the board of directors.[116] There is no statutory right to direct representation on the board. Although cumulative voting might be moderately useful in achieving its purposes in a corporation with a small number of shareholders, or one with another form of concentrated ownership, in such cases there are usually better mechanisms available.[117]

Cumulative voting was designed as a compensatory mechanism to override the principle of majority rule, whereby a ma-

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114. The accepted story of the introduction of cumulative voting in the United States is truly a bit bizarre:

> As part of the Illinois constitutional revision of 1870, adherents of proportional representation won a major battle to require cumulative voting for the Illinois House of Representatives. The principle having prevailed, the constitutional convention also required cumulative voting in the election of directors for private corporations. The objective was to protect minority interests against overreaching by a majority, particularly in circumstances in which representation on the board would give the minority the information necessary to police against fraud.

Jeffrey Gordon, *Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 142 (1994).

115. "One undesirable aspect of cumulative voting is that it tends to be a little tricky. If a shareholder casts votes in an irrational or inefficient way, he may not get the directorships his position entitles him to; when voting cumulatively it is relatively easy to make a mistake in spreading votes around." ROBERT W. HAMILTON & JONATHAN R. MACEY, CASES AND MATERIALS ON CORPORATIONS 534 (8th ed. 2003).

116. For a historical analysis of cumulative voting, see Gordon, *supra* note 114.

117. Shareholder agreements and the use of voting groups, for example.

jority shareholder, through voting procedures, could elect an entire slate to the board of a U.S. corporation.[118] In the United States, the original statutory formulation became a mandatory feature in many state laws.[119] Over time, however, partly in response to the shift to more manager-friendly corporate laws in the United States, cumulative voting started to slip back into the realm of private legal rules; it remained a feature of corporate statutes, but was made optional in most states.[120] Thus, cumulative voting was made permissive, not mandatory, in most states and ultimately left to determination in the corporate charter.[121] German corporate law, on the other hand, has long provided a statutory mechanism to ensure direct supervisory board representation by certain constituencies—a statutory right to direct representation.[122]

In the aftermath of the 1997 Asian financial crisis, Korea acted quickly to re-establish confidence in its markets.[123]

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118. For a description of the operation of cumulative voting, see HAMILTON & MACEY, *supra* note 115, at 534.

119. *See* Gordon, *supra* note 114.

120. *Id.* at 155–60. *See also* HAMILTON & MACEY, *supra* note 115, at 541

> ("Under the MBCA [Model Business Corporations Act], cumulative voting, like preemptive rights, is an 'opt in' election to be chosen by an appropriate provision in the articles of incorporation. As of 1998, thirty states had adopted an 'opt in' provision while twelve states had an 'opt out' election. Eight states make cumulative voting mandatory for all corporations, five by provision in state constitutions. The number of states with mandatory cumulative voting, however, is declining. In 1990 California, long the bastion of mandatory cumulative voting, made that manner of voting permissive for corporations with shares listed on a public exchange or with more than 800 shareholders of record.").

121. Gordon posits two propositions for the demise of cumulative voting in the United States: "The evidence suggests two very different hypotheses: one holds that cumulative voting fell victim to a managerial race to the bottom; the other posits that cumulative voting, even if once useful, *came to interfere with good governance."* Gordon, *supra* note 114, at 141–42 (emphasis added).

122. *See* SCHLESINGER ET AL., *supra* note 36, at 892 ("In Germany, under the system of *Mitbestimmung* (co-determination), workers elect normally one third of the supervisory board.").

123. As Kim points out,

> The 1997 financial crisis exposed a wide range of structural weaknesses in Korea's economy. International organizations such as the International Monetary Fund ("IMF") and the International Bank for Reconstruction and Development ("World Bank"), in particular, criti-

Among other things, waves of corporate law reforms were enacted, some at the suggestion of international financial institutions such as The World Bank and the IMF, with cumulative voting provisions among them. The cumulative voting rules adopted, though, were of the "weak," or quasi-public, variety. They were not mandatory in that they could be bypassed through amendments to the corporate charter. Although some Korean academics had queried, prior to enactment, the effectiveness of these "optional" or "default" rules,[124] they had been advised that this was a modern formulation of the rule as found in the United States.

As a result, Korean corporations moved quickly, and predictably, to neutralize cumulative voting rules by charter amendments, rendering the statutory rules ineffective.[125] But then, cumulative voting was inherently ineffective in any case, as it so proved in Korea. "Even among those companies that have not excluded [cumulative voting] and…therefore must follow it, to date there have been no reports that a company has elected a director through cumulative voting."[126]

> cized Korea's corporate sector and blamed ineffective corporate regulation as a major cause of the crisis….In return for receiving their financial assistance, Korea enacted another round of extensive amendments to its corporate laws on December 28, 1998….Finally, on December 31, 1999, several additional amendments were enacted.

Kim, *supra* note 110, at 276.

124. Conversation with Hasung Jang, Director, Asian Institute of Corporate Governance, Korea University Business School, in Washington, D.C. (Sept. 2000).

125. *See* Jang & Kim, *supra* note 111.

126. *Id*. at 3

> ("As of 1998, cumulative voting has become an option for companies. Unfortunately, from a policy standpoint, it has remained largely ineffective. The problem lies in that when the Commercial Code was amended to allow cumulative voting the new law also included a provision that permits companies to exclude it through their articles of incorporation. (CC382-2). As a result, as of November 2000, 77.6% of all listed companies have adopted provisions in their articles that specifically exclude cumulative voting.…The new SEC has attempted to ameliorate this situation by requiring that shareholders with at least one percent of the voting stock can request cumulative voting. (SEC 191-18). This substantially lowers the previous holding requirement of three percent that still applies to non-listed companies. The new SEC also tries to reverse the trend of excluding cumulative voting and has stopped just short of mandating it.").

Wrong rule, wrong form of rule. A German-style rule providing for direct board representation, a substantive right rather than a dubious procedural mechanism, would likely have been more compatible with the underlying German framework of the corporate law (even as it had become denatured by earlier U.S. transplants)[127] and, thus, more effective. Some commentators had actually suggested a more German style rule, but did not prevail.[128] And, if an effective cumulative voting rule had still been the desired result, a mandatory statutory provision would have been more effective.[129]

However, the overriding question of whether cumulative voting actually promotes better corporate governance, even in the United States, has never been satisfactorily answered.[130] Cumulative voting does appear, in its "weak" or "optional" form, in most state statutes in the United States. Its operation is discussed, sometimes at length, in U.S. law texts.[131] In other words, the cumulative voting mechanism is a visible tip of the iceberg. However, cumulative voting rights are not very effective as a minority shareholder protection mechanism under any circumstances, and particularly not in a listed or publicly-

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127. With respect to the adoption of the U.S.-style board of directors in Japanese law, it was said at the time, "On a Commercial Code of continental origin, there have been forcibly grafted certain limbs of alien, Anglo-American origin." Kim, *supra* note 111, at 277 n.13 (quoting Thomas I. Blakemore & Makoto Yazawa, *Japanese Commercial Code Revisions: Concerning Corporations*, 2 AM. J. COMP. L 12, 15–16 (1953)).

128. According to Kim,

> One observer argues that Korea is not ready for the cumulative voting system because it will create confusion...Choi proposes instead a new system of corporate governance whereby 50% of the board would be elected as before, 35% would be elected with each shareholder's voting rights being limited to a maximum of 3%, and the remaining 25% would be elected by large creditors….For companies with more than 10,000 workers, a representative from the workers would be elected.

Kim, *supra* note 110, at 295 n.107.

129. Jang & Kim, *supra* note 111.

130. Gordon, *supra* note 114, at 127 ("[T]he evidence is far from clear that cumulative voting increases aggregate shareholder welfare across all firms at all times.").

131. *See* HAMILTON & MACEY, *supra* note 124.

traded U.S. corporation.[132] Since the greater corporate governance debate implicates only publicly traded corporations, cumulative voting rights are thus more or less irrelevant.[133] Cumulative voting provisions are fossils trapped in the bedrock of U.S. corporate statutes.

This raises the question of how cumulative voting provisions gained international prominence as a corporate governance mechanism. The highly regarded and influential LLSV studies are a likely culprit.[134] In the difficult search to isolate econometric indicia of shareholder protections, the statutory provisions in U.S. corporate law on cumulative voting were visible and accessible. That cumulative voting rights, as a minority shareholder protection, were irrelevant to publicly-traded corporations in the United States was not immediately obvious.[135] The

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132. Irrespective of whether cumulative voting mechanisms are available, minority shareholder voting rights in U.S. publicly-traded corporations are largely illusory. Unlike many other places in the world (including the UK and continental Europe), the residual authority in a corporation does not reside in the general meeting of shareholders. In particular, the control of the nomination process by the directors themselves, together with management control of the proxy voting process in the United States, means that minority shareholder voting rights count for very little. Shareholders may only vote for (or abstain from voting for) the slate of directors put before them by management:

> [T]here is one big problem with demanding more activism from shareholders; their votes in America are still largely worthless, as this season's proxy season, which has just begun, will show once again. Despite all the talk in America about shareholder democracy and ownership, shareholder resolutions, even if backed by a majority, are rarely binding on management. In many cases, managers can even stop a resolution from being put to a vote. The Securities and Exchange Commission recently proposed a tiny rule change to make it slightly easier for shareholders to nominate candidates for election to boards of directors. Lobbyists representing America's top bosses easily and unceremoniously killed the proposal.

Bossing the Bosses, ECONOMIST, Apr. 9, 2005, at 13.

133. Mark Roe notes, "Wall Street lawyers might have reservations about heavily using preemptive rights, cumulative voting and the minimum percentage needed to call a special shareholders meeting—items not likely to be near the top of most American lawyers' lists of Delaware corporate law's most important legal protections." MARK J. ROE, CORPORATE LAW'S LIMITS 29 n.37 (Colum. Law School, Ctr. for Law and Econ. Studies, Working Paper No. 186, Jan. 16, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=260582 (last visited May 20, 2005).

134. *See supra* note 2.

135. Except to Wall Street lawyers, perhaps.

complexity and dynamism of legal systems present difficult challenges for econometric analysis.

However, it gets worse: the "defect" in the cumulative voting provision in Korea was "fixed."[136] A form of mandatory cumulative voting has proven to be worse than merely irrelevant for Korean corporations with voting shares trading in the United States. It is virtually impossible to reconcile mandatory cumulative voting provisions with the already difficult U.S. proxy voting rules and practices for publicly-traded corporations.[137] Further, like most other non-U.S. issuers,[138] shares of Korean corporations will usually be traded through a derivative form of security, known as American Depository Receipts, thus adding further devilish complexity to the voting process.[139]

H. Class Actions

Class actions present even less likelihood of effectiveness as a governance mechanism in most transitional and emerging markets. At least with cumulative voting, there would be a chance of developing rules that could, technically, work in the context of corporate legislation to which they were not native. Class actions, however, depend upon the existence of an experienced judiciary, an extensive network of other procedural rules, an active body of litigation professionals and, in terms of particular legal sensibilities, a general populace with a litigious bent.[140]

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136. *See* JANG & KIM, *supra* note 111.

137. As noted *supra* Section VI(g), the vast majority of U.S. publicly-traded corporations do not have cumulative voting provisions, so the proxy voting rules are not designed to take them into account.

138. Canadian and Israeli issuers being notable exceptions.

139. For example, refer to the 2005 U.S. proxy materials for KT (formerly known as Korea Telecom Corp.) which has American Depositary Receipts (ADRs) trading in the United States. (Proxy materials on file with author). The complexity of the voting procedures, resulting from the use of cumulative voting, would astonish a U.S. issuer of publicly traded securities. In the case of KT, it is interesting to note that cumulative voting was at the behest of its labor union. "Under the Korean Commercial Code and Securities Exchange Act, anyone who holds more than 1% of shares of KT with voting rights can request cumulative voting. In this case, Mr. Ji Jae Shik, a shareholder, requested cumulative voting on February 23, 2005. Please note that this request process was actually initiated by KT Labor Union."

140. *See generally* HON. JACK B. WEINSTEIN, INDIVIDUAL JUSTICE IN MASS TORT LITIGATIONS: THE EFFECT OF CLASS ACTIONS, CONSOLIDATIONS, AND OTHER MULTI-PARTY DEVICES (1995).

Class actions form part of the body of procedural law, in the great common law tradition of no right (or wrong) without a remedy.

So-called "class action" provisions dropped into otherwise substantive corporate law of a transitional or emerging market economy would arrive dead on arrival. There would be no procedural rules or institutions to support them, much less the inclination to make use of them, were such rules to develop.[141]

VII. TENTATIVE CONCLUSIONS

Following a dozen or so years of "a massive process of change in adherence to legal information," as H. Patrick Glenn puts it, a huge, slow, process of digestion and "indigenization" is now ongoing.[142] Like a boa constrictor enjoying a good meal, there is no doubt that in certain places, at certain times, some bits may be spat out or pass through without leaving a trace. There is equally little doubt that what is ingested will be transformed by the process.

In terms of mobilizing the forces of the capital markets effectively to raise standards of governance in corporations, the Latin American experience may be particularly instructive.[143] The initiatives differ among themselves, depending on various factors such as prevailing forms of corporate ownership and capital structure. Not every initiative may be directly transferable elsewhere in all cases, but there may be positive lessons to be learned.

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141. Between 1998 and 2002, there were only thirteen suits filed by minority shareholders in Korea. *See supra* note 44.

> One recent reform intended to impose discipline on managers and majority shareholders is the availability of class action suits. The new law passed by the National Assembly, the Securities Related Class Action Law, will allow shareholders to file class actions from January 1, 2005, in respect of companies with Won 2 trillion or more in assets….

Kyung Taek Jung & Hwa Soo Chung, *Korea Aims for World Class Corporate Governance*, INT'L FIN. L. REV., Apr. 2005, *available at* http://www.legalmediagroup.com/iflr/default.asp?Page=1&SID=5710&F=F.

142. *See generally* Legrand, *supra* note 20.

143. For more detailed analysis of Latin American initiatives in corporate governance, see Jordan & Lubrano, *supra* note 48.

Latin Americans are proving adept at legal transplantation because they have the advantage of proximity and exposure to North American law, markets and practices. For example, both Mexico and Quebec, French civil code jurisdictions, can fearlessly introduce Anglo-American trust law concepts, and make them work, because they understand the principles and have a long history of familiarity with them. Further, the integration of the North and South American capital markets means that Latin Americans want to make the new concepts work, a good predictor of effectiveness according to Pistor.[144] In addition, capital market integration along this north/south axis is well advanced and the international signaling imperative is at work.[145] Further, Latin Americans are introducing governance mechanisms in multiple guises along the continuum of private and public legal rules in order to amplify the prospects of effectiveness.

Brazil's initiatives are particularly interesting in moving contractual governance mechanisms (private legal rules) into the listing rules (semi-public legal rules) and then backing them with corresponding legislative changes (*ex ante* public legal rules). The BOVESPA's Novo Mercado has elicited attention elsewhere.[146] It may prove to be good vehicle for maximizing the effectiveness of capital markets forces on the governance of corporations. Time will tell.

Of course, these observations have been based on recent, but past, experiences. There are now several new factors to consider. The corporate governance scandals in the United States have shaken confidence in the old, familiar mechanisms of capital market and corporate governance.[147] The formal, public response to the scandals, embodied in the Sarbanes-Oxley legislation,[148] is more a symptom than a solution. New approaches are

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144. *See* PISTOR, *supra* note 3.

145. *See* COFFEE, COMPETITION AMONG SECURITIES MARKETS, *supra* note 4.

146. The Jakarta Stock Exchange, for example, and its capital markets regulator, BAPEPAM, for example, were interested in the Brazilian experience.

147. The Enron and WorldCom scandals being the most prominent, and the proximate cause of the Sarbanes-Oxley legislation. *See* Mark J. Roe, *Delaware's Competition,* 117 HARV. L. REV. 558 (2003).

148. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) [hereinafter Sarbanes-Oxley Act].

appearing elsewhere, notably in Europe.[149] Europe is also providing new models of capital market regulation, controversial and untested though they may be, in the form of the EU Prospectus Directive, for example, which comes into effect in July 2005. Revitalized European stock markets, together with a new pan-European regulatory structure, may be more compatible with and change the dynamics of the legal systems of any number of countries. And finally, could it be that an older style of commercial morality and heightened legal sensibilities are creeping back into U.S. boardrooms?[150]

149.

> If William Donaldson is looking for ways to shake up the U.S. stock markets, as the Securities and Exchange Commission chairman appears poised to consider, he might want to look at Europe. European's [sic] stock markets have their own flaws, but in the past decade have taken just the kind of steps to electronic and cheap exchanges overseen by independent regulators that could now be in play in the U.S. The pressure for change in the U.S. markets comes in the wake of an outcry over the perceived lack of corporate governance at the New York Stock Exchange and the forced resignation of its chief executive, Dick Grasso.

Model Market Could be in Europe, WALL ST. J., Sept. 25, 2003, at C14.

150. Sarbanes-Oxley Act does require disclosure of whether reporting corporations have an ethics committee. *See* Sarbanes-Oxley Act § 406. *See also Boeing Chief Quits Over Affair*, FIN. TIMES, Mar. 8, 2005, at 1

> ("Harry Stonecipher, the man brought out of retirement to restore Boeing's reputation, was ousted as chief executive yesterday for having an affair with a female executive. The departure is a serious blow to Boeing, which is working hard to restore its reputation. A series of executives has left under a cloud….The episode also raises questions about how far corporate ethics should reach into personal lives.").