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CONVERGENCE IN CORPORATE GOVERNANCE—POSSIBLE,
BUT NOT DESIRABLE

BRETT H. McDONNELL*

*"There are more things in heaven and earth, Horatio
Than are dreamt of in your philosophy."*

—William Shakespeare, *Hamlet*

*"East is east and west is west
The twain shall meet."*

—John Lennon, *You Are Here*

I. INTRODUCTION

THE prospects for international convergence in corporate governance systems have become a hot topic in legal academia. For some time scholars have depicted American corporations and capital markets as optimal adaptations for governing large business enterprises.¹ More recently, American scholars have become more aware that other countries do things rather differently. While large American corporations have many dispersed shareholders and turn to public stock and bond markets for financing, large Japanese and German corporations have more concentrated shareholders and close financial relations with banks.

The differences have led scholars to ask several basic questions. Why did corporate governance systems develop differently in these different countries?² Which system does a better job at solving the problems of corporate governance?³ Will corporations in different countries converge to a similar system of corporate governance?⁴ The dominant answers to

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1. See generally Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 449 (2001) (discussing how American corporations are "superior" for governing large business enterprises).

2. See Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927, 1928-29 (1993) (examining historical and political influence on corporate governance). See generally JONATHAN P. CLARKHAM, *KEEPING GOOD COMPANY: A STUDY OF CORPORATE GOVERNANCE IN FIVE COUNTRIES I* (1994) (attributing differences to historical, social, political and economic forces).

3. For a discussion on the problems of corporate governance, see *infra* notes 42-46 and accompanying text.

4. See generally CLARKHAM, *supra* note 2, at 1 (describing importance in studying other systems so countries can remain competitive and suggesting possibility of convergence).

the last two questions, among elite American legal scholars, are currently that the American system works better and that the other countries are in the process of converging to the American system. Though there is some dissent from this position, the main debate has been over why countries outside the United States have persisted for so long in their benighted systems and what form their convergence to the American way will take.

The scholarly discussion has converged too quickly on the convergence answer. The universe of theoretical possibilities is much richer than a dominant strand of the literature suggests, and we are currently far short of the sort of empirical evidence that might help us sort out these possibilities. Most commentators have focused on efficiency to the exclusion of other values. Moreover, even if convergence occurs, there is a possibility that we will not converge on the best system. Even if we converge to the current best system, convergence still may not be desirable.

This Article, divided into seven sections, fleshes out the points made in the previous paragraph. Following this introduction, Section II briefly surveys the literature on convergence. Section III explores four idealized stories, comparing the evolution to date of corporate governance systems in the United States⁵ on the one hand and Japan and Germany⁶ on the other hand. The four stories are ideal types; reality will fall somewhere in between them. I label the four stories P1 through P4 (past story 1 through past story 4). P1 posits that American institutions have followed a path to an optimal system, while Japanese and German institutions have followed a sub-optimal path. P2 is the opposite story: Japanese and German institutions have followed an optimal path, while American institutions have not. P3 maintains that the United States has followed a different path than Japan and Germany, but one cannot meaningfully say that either of the different systems is superior. Finally, according to P4, Japan and Germany are on the same basic path as the United States, though on a variant of P4 those countries may be somewhat behind the United States on that path. Section III presents a variety of arguments in favor of these different stories and canvasses some empirical evidence on their relative merits.

Section IV similarly explores four different paths that corporate governance systems may follow in the future. Under F1 (future story 1), bank-centered systems such as those in Japan and Germany will converge to a market-centered system such as that in the United States. F2 is the opposite: the American market-centered system will converge to a bank-cen-

5. Much of what I say for the United States would also hold true for the United Kingdom, but I focus here only on the United States.

6. Japan and Germany have some significant differences between themselves, but except as noted below, at the level of generality considered in this Article it is probably safe to consider them as similar systems, in contrast with the U.S. system. Other European countries are generally closer to Germany than to the United States, but there are some quite significant differences as well. A very interesting question, but one I leave aside here, is the extent to which the greater integration of the European Union will bring corporate governance in the member countries closer to each other.

tered system. F3 posits a hybrid possibility: the bank-centered and market-centered systems will converge to a hybrid system, which combines elements of both. Finally, according to F4, the countries will remain (or become) distinct. Section IV also surveys some evidence as to how the different systems appear to be changing, or not changing, at this point.

Section V relates the stories developed in Sections III and IV. Each story of how we got to where we are today (Section III) may potentially be combined with any one of the stories of where we are going (Section IV). For instance, the dominant convergence story combines P1 (the American system has evolved optimally) with F1 (Japan and Germany will converge to the American system). Conceptually, this leads to sixteen possible combinations of past and future stories. Section V argues that at this point we do not have very good reasons to choose among these scenarios. At first blush, some combinations may appear implausible. For instance, if P1 is true and the American system is optimal, then why would the United States converge to the Japanese and German system, as F2 posits? Yet, Section V presents a variety of arguments as to why this could happen. At the end of the section, I hypothesize that the most likely combination is P3 and F3. That is, the United States has, up to now, followed a different path from Japan and Germany, but we cannot meaningfully say that one system is overall superior to the other. In the future, the systems will converge to a hybrid system, but one much closer to the United States than to Japan or Germany. I believe that this is the single most likely possibility of the sixteen; however, it is more likely that one of the other fifteen possibilities will turn out to be closer to the truth.

Section VI asks the normative question as to how we should evaluate the various possibilities presented in Section V. It would seem obvious that if P1 is true and the American system is the superior one among those currently existing, then F1 would be the best future option—that is, it would be best if other countries converged to the American system. It is not really so obvious, however. Even if the American system is superior under current circumstances, other systems may become preferable as future circumstances change. We should therefore preserve international organizational variety so that there are more options available for future evolution.

Section VII concludes with a call for greater balance in the treatment of corporate governance systems by academics, policymakers and opinion-setters.

II. THE CONVERGENCE LITERATURE

Economists as well as legal scholars have noted some major differences in corporate governance between the United States, on the one hand, and Japan and Germany, on the other hand.⁷ In a very stylized

7. See, e.g., FRANKLIN ALLEN & DOUGLAS GALE, *COMPARING FINANCIAL SYSTEMS* 4 (2000) (sharing differences between nations regarding financial markets, banks

rendering, the differences are as follows. American firms rely more on stock and bond markets for external financing. The norm is that corporations are to be governed in the interests of their shareholders.⁸ Although those shareholders are dispersed with relatively small holdings, creating a free rider problem in shareholder monitoring of management, the threat, and sometimes the reality, of corporate takeovers serves as a major disciplinary device.⁹ Active external labor markets for managers also provide an incentive to do a good job.¹⁰ Corporate laws provide relatively extensive protections for shareholders, and courts are relatively active in enforcing those protections.

The landscape looks different in Japan and Germany. Companies there rely more on banks for external financing. Large companies generally have one bank—a main bank in Japan, and a universal bank in Germany¹¹—that is heavily involved with the company at a variety of levels, including holding shares in the company as well as lending to it. Those banks specialize in monitoring the companies with which they are involved and may intervene more actively in troubled companies than do their American counterparts.¹² Shareholdings are more concentrated than in

and external corporate governance); CLARKHAM, *supra* note 2, at 349-66 (contrasting governance laws in Japan, Germany, United Kingdom and others); COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH v-vi (Klaus J. Hopt et al. eds., 1999) [hereinafter COMPARATIVE CORPORATE GOVERNANCE] (noting that book focused on corporate governance systems in Japan, Europe and United States); Masahiko Aoki, *Toward an Economic Model of the Japanese Firm*, 28 J. ECON. LIT. 1, 2 (1990) (noting that Japanese model “is at odds” with Anglo-American model); Roe, *supra* note 2, at 1928-29 (describing difference between nations in corporate law, history and politics).

8. *But see Symposium: Corporate Malaise—Stakeholder Statutes: Cause or Cure?*, 21 STETSON L. REV. 1, 23-252 (1991) (collecting articles discussing growth of corporate constituency statutes).

9. See FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 76 (1991) (“It is true that in public corporations directors are rarely evicted in midterm, but the possibility of ouster may be sufficient to ensure that directors act as faithful agents . . .”); Henry Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112-13 (1965) (describing how poor management lowers stock price, thereby attracting take-over candidates).

10. See Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 293-95 (1980) (showing how external manager labor market influences manager performance because likelihood of securing or retaining job depends on success of company).

11. “Main bank” refers to the bank with which a Japanese firm has a special long-term relationship. Main banks typically provide loans, hold equity in the firm and are expected to monitor the firm’s performance. “Universal banks” in Germany provide a wide range of financial services, including deposits, securities services, dealing in real estate, and so on.

12. See Aoki, *supra* note 7, at 14–18 (describing differences between American and Japanese monitoring of companies in “bad profit states”); George J. Benston, *Universal Banking*, 8 J. ECON. PERSP. 121, 122-23 (1994) (describing differences between American and Japanese investment banking operations); Paul Sheard, *Main Banks and the Governance of Financial Distress*, in *THE JAPANESE MAIN BANK SYSTEM* 188, 188 (Masahiko Aoki & Hugh Patrick eds., 1994) (discussing role banks play when client firms encounter financial difficulty). *But see* Ekkehard Wenger &

the United States. In the case of Germany, wealthy individuals and families as well as nonfinancial firms tend to be the large blockholders. In Japan, nonfinancial firms and the banks are involved in an extensive series of cross-holdings among inter-related groups of firms. The general norm is that companies are to be run in the interests of both shareholders and employees, not just shareholders.¹³ Takeovers are rare, and managerial promotion is internal within companies, rather than across companies. Corporate laws provide weaker protections for shareholders and are less frequently enforced.

Some people think these differences are overstated, and we shall consider that position below. Note that the differences mainly look to differences in the governance of large public corporations—small, closely held businesses probably look more similar in the three countries. The differences at the large corporation level, however, do have some implications for smaller companies as well. For instance, the venture capitalist model of governance for high tech startups has been important for recent American success. Such startups are governed much differently from large public corporations. Nevertheless, the availability of broad, American-style stock markets to provide an exit strategy for investors in such startups is probably crucial to the functioning of the venture capital system.¹⁴

For the moment, let us accept that there are some such differences between countries in corporate governance. Their existence prompts questions such as: Why do the differences exist? Does one system work better than the other? Is there any tendency for one of the systems to come to resemble the other over time, particularly as globalization spreads and competition between companies in different countries becomes more intense? These are some of the major questions faced in the field of comparative corporate governance.

The literature on convergence in corporate governance is not static; it has shifted significantly over the last decade.¹⁵ However, for the broadest and boldest statement of the view that currently dominates American legal academia, one should peruse *The End of History for Corporate Law* by Henry Hansmann and Reinier Kraakman.¹⁶ Hansmann and Kraakman believe

Christoph Kaserer, *German Banks and Corporate Governance: A Critical View*, in COMPARATIVE CORPORATE GOVERNANCE, *supra* note 7, at 499, 522 (claiming that German corporate governance system “cannot work very well” due to bank influence and lack of disclosure obligations).

13. See CLARKHAM, *supra* note 2, at 360-61 (describing Japanese and German corporate accountability); Aoki, *supra* note 7, at 20 (describing dual control by financial and employees interests over corporate decision-making).

14. For an explanation on how liquid markets support venture capitalization, see *infra* note 46.

15. This section is not by any means a comprehensive survey of the literature on convergence in corporate governance. That literature is fairly extensive and growing rapidly.

16. See generally Hansmann & Kraakman, *supra* note 1 (arguing shareholder-centered ideology dominates corporate governance, resulting in little variation in corporate governance practice).

they have spotted a growing consensus in academia, business and government in favor of a shareholder and market-oriented model of corporate governance along American lines.¹⁷ They consider various alternative models and find them wanting—based on very little evidence, it must be said. They also point to some limited evidence of movement towards the American model in Europe and Japan as proof of their thesis.¹⁸ Capital markets and institutional investors prefer the American model and are helping to export it elsewhere because it has proved its superiority in practice.¹⁹ Thus, they think the world is converging to the American way, and that is a good thing.

Nothing else in the literature is quite so sweeping as Hansmann and Kraakman, but a number of other scholars seem to accept the basic point. John Coffee²⁰ and Ronald Gilson²¹ distinguish formal and functional convergence. Formal convergence refers to companies coming to be governed by the same legal forms. Coffee and Gilson believe that formal convergence is probably a long way away. Nevertheless, they argue that different formal institutions in different countries may come to play the same function. For instance, shareholder protections may be created through rules imposed by stock exchanges rather than imposed by corporate law and courts.²² Coffee and Gilson assert that functional convergence to the American model is developing rapidly and will continue to do so. They point, for instance, to the growing number of non-American companies which are choosing to list on American stock exchanges, thereby binding themselves to follow corporate governance rules required for companies listed on those exchanges.

17. See *id.* at 440-41 (discussing growing consensus and its principle elements).

18. See *id.* at 452 (describing increase in stock ownership and corporate governance reform in Europe and Japan).

19. See *id.* at 451 (noting that equity investors prefer American model).

20. See JOHN C. COFFEE, JR., CONVERGENCE AND ITS CRITICS: WHAT ARE THE PRECONDITIONS TO THE SEPARATION OF OWNERSHIP AND CONTROL? 2-5 (Columbia Law and Economics, Working Paper No. 179, 2000), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=241782 (describing separate convergence theories); John C. Coffee, Jr., *The Future As History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 646-47 (1999) (asserting multiple factors create different types of convergence).

21. See RONALD J. GILSON, GLOBALIZING CORPORATE GOVERNANCE: CONVERGENCE OF FORM OR FUNCTION, 7 (Stanford Law and Economics Olin, Working Paper No. 192 and Columbia Law and Economics, Working Paper No. 174, 2000), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=229517 (indicating prediction whether convergence will be formal or functional is focus of article); see also Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U. L.Q. 327, 342-43 (1996) (differentiating functional convergence).

22. See GILSON, *supra* note 21, at 26 (discussing Coffee's second example of convergence by contract, convergence through stock exchange listing).

Other legal scholars who argue that some kind and degree of convergence to the American model is occurring include Lawrence Cunningham,²³ Jeffrey Gordon,²⁴ Mary Kissane²⁵ and Gustavo Visentini.²⁶

Scholarly fashion looked rather different a decade ago. In the 1980s Japanese companies seemed to be outcompeting American companies. Many economists pointed to advantages of the Japanese system.²⁷ In legal academia, Mark Roe wrote a series of papers and a book arguing that populist-inspired laws had prevented the United States from developing a similar system of bank-led capitalism, calling into question whether the American system had evolved optimally.²⁸ Others also wrote papers extolling the advantages of Japan, although some scholars countered with articles examining disadvantages of the Japanese system.²⁹

Today, Roe is still contributing papers suggesting a path-dependent, politics-driven evolution of different systems in different countries.³⁰ Now, though, Roe seems to concentrate more on political limits to the

23. See Lawrence A. Cunningham, *Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance*, 84 CORNELL L. REV. 1133, 1143-46 (1999) (predicting partial convergence to hybrid model, but one whose core features appear more typical of American model).

24. See Jeffrey Gordon, *Pathways to Corporate Convergence? Two Steps on the Road to Shareholder Capitalism in Germany*, 5 COLUM. J. EUR. L. 219, 219-20 (1999) (seeing cross-border acquisitions as force tending to lead to convergence to American system).

25. See Mary E. Kissane, *Global Gadflies: Applications and Implications of U.S.-Style Corporate Governance Abroad*, 17 N.Y.L. SCH. J. INT'L & COMP. L. 621, 626-33 (1997) (discussing role of shareholder activism in leading to convergence).

26. See Gustavo Visentini, *Compatibility and Competition Between European and American Corporate Governance: Which Model of Capitalism?*, 23 BROOK. J. INT'L L. 833, 846-48 (1998) (focusing on increasing international competition among financial institutions).

27. See, e.g., MICHAEL E. PORTER, CAPITAL CHOICES: CHANGING THE WAY AMERICA INVESTS IN INDUSTRY 19 (1992) (discussing investment reforms that could allow United States to surpass Japan); Aoki, *supra* note 7, at 24 (describing advantages of Japan's horizontal coordination compared to hierarchical coordination); Michael C. Jensen, *The Eclipse of the Public Corporation*, 67 HARV. BUS. REV. 61, 63 (1989) (praising Japanese governance laws).

28. See MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 283-87 (1994) (indicating American governance system developed inefficiently); Roe, *supra* note 2, at 1930 ("These laws, necessary to fully understand the American public firm, have been the San Andreas fault line in American corporate governance historically severing America's largest financial institutions from its largest industrial firms."); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 10-11 (1991) (arguing that American public corporation is political adaptation).

29. See, e.g., Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 STAN. L. REV. 73, 81-89 (1995) (arguing that Japanese governance structure precludes robust control market); Roberta Romano, *A Cautionary Note on Drawing Lessons from Comparative Corporate Law*, 102 YALE L.J. 2021, 2023-30 (1993) (producing evidence of Japanese system's inferiority).

30. The idea of path dependence in this context basically says that once a country has settled on a basic corporate governance system, it will have much

Japanese and German systems.³¹ Still, Roe's work on path dependence in corporate governance provides a theoretical basis for questioning recent work on convergence.³²

A few other legal scholars have also questioned the convergence thesis. Douglas Branson³³ and Amir Licht³⁴ have suggested that cultural values will ensure that governance systems and laws remain quite diverse around the world. Branson and Licht also take a much more genuinely global perspective than most of the legal literature, which tends to focus mostly on the United States, parts of Europe and Japan. Evidence for corporate governance convergence outside these economically developed countries is certainly much weaker.

I should also mention a series of papers by four economists (the "gang of four"), which has had an important influence on the convergence literature.³⁵ The gang has examined the relationship between laws and corporate governance using systematic data from dozens of countries.³⁶ Their work suggests that laws that protect minority shareholders and bondholders, which are more likely to develop in common law countries, lead to the development of larger and more liquid capital markets,

trouble switching to an alternative system, even if that alternative system has proven itself better. See *infra* notes 76-91 and accompanying text.

31. See Ronald J. Gilson & Mark J. Roe, *The Political Economy of Japanese Lifetime Employment*, in EMPLOYEES AND CORPORATE GOVERNANCE 239, 239-71 (Margaret M. Blair & Mark J. Roe eds., 1999) (discussing politically-mandated lifetime employment); Mark J. Roe, *Codetermination and German Securities Markets*, in EMPLOYEES AND CORPORATE GOVERNANCE, *supra*, at 194, 194-204 (discussing block, family ownership and codetermination in German corporation).

32. See Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127, 169-70 (1999) (indicating path-dependency alternative to convergence).

33. See DOUGLAS M. BRANSON, THE VERY UNCERTAIN PROSPECT OF "GLOBAL" CONVERGENCE IN CORPORATE GOVERNANCE 6 (University of Pittsburgh School of Law, Working Paper, 2000), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=244742 ("The global convergence in corporate governance's scholarship tramples on the diversity of cultures present in the world . . .").

34. See Amir N. Licht, *The Mother of All Path Dependencies—Toward a Cross-Cultural Theory of Corporate Governance Systems*, 26 DEL. J. CORP. L. 147, 149-50 (2001) (indicating culture may affect governance laws); see also AMIR N. LICHT ET AL., CULTURE, LAW AND FINANCE: CULTURAL DIMENSIONS OF CORPORATE GOVERNANCE LAWS 4 (Interdisciplinary Center Herzliya, Working Paper, 2001), available at http://papers.ssrn.com/paper.taf?abstract_id=267190 (claiming that cultural values impact governance laws).

35. See generally Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999) [hereinafter La Porta et al., *Corporate Ownership*] (examining controlling shareholders in different countries); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998) [hereinafter La Porta et al., *Law and Finance*] (examining legal rules covering protection of corporate shareholders and creditors); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) [hereinafter La Porta et al., *Legal Determinants*] (describing legal environment and influences on capital markets in various countries).

36. See La Porta et al., *Legal Determinants*, *supra* note 35, at 1131-32 (describing various studies conducted).

with more dispersed shareholdings of companies.³⁷ They also suggest that companies in countries with larger capital markets are more productive. Even if one accepts their results,³⁸ the implications for the convergence debate are uncertain, as one would need to add in a theory of political economy to predict whether countries with less protective laws are likely to modify those laws so that they can develop more effective capital markets.

I want to briefly acknowledge and then ignore one point Branson emphasizes.³⁹ Most of the convergence scholarship does indeed focus on a few wealthy countries in Europe, North America and part of East Asia. I shall do the same. It is true that outside this limited sphere the prospects for convergence to an American corporate governance model are certainly dimmer. However, I am concerned here with governance models that will allow companies to achieve high levels of productivity. The American and the Japanese-German models, to date, have been the only main models that have proven able to do this on a mass scale. Although many individuals may eschew the materialism rampant in those countries, I rather strongly suspect that most countries that have yet to achieve similar levels of productivity have not done so voluntarily. If they could achieve that same productivity and resulting level of wealth, they would do so.

This is not to say that the two models I consider here are necessarily the best possible alternatives. Someone someday may come up with something better. Indeed, perhaps someone already has, but it has not yet achieved mass success. Who could reasonably claim to know the best possible model of corporate governance for all time and circumstances yet to come?⁴⁰ Perhaps Hansmann and Kraakman, if one takes the "end of history" phrase in their title seriously, but ordinary mortals may want to be more circumspect in their claims. For us, though, these two models are the main ones currently available for consideration.

III. FOUR STORIES OF THE PAST

In this section, I present four competing idealized stories about where we are today and how we got there. The four stories are ideal types; a continuum of possibilities lies between the ideals. Reality almost certainly lies in that in-between world. Probably no serious scholar believes any of the pure stories. Nevertheless, I hope that the stories help clarify thought.

37. See La Porta et al., *Corporate Ownership*, *supra* note 35, at 511 (finding equity markets both broader and more valuable in countries with good legal protection of minority shareholders).

38. I have my doubts about the direction of causality. I do not think they have convincingly ruled out the possibility that developed capital markets give rise to pressure to protect bondholders and minority shareholders, rather than the reverse.

39. See BRANSON, *supra* note 33, at 7-8 (arguing that convergence theorists ignore most nations).

40. This question, indeed, is at the core of my argument for continued international diversity in corporate governance. See *infra* Section VI (arguing need for diversity and variability).

The first three stories differ in their evaluation of which system, if any, has evolved optimally. As a preliminary note I must, therefore, consider what standards to use in describing a corporate governance system as “optimal” or “superior.” As an economist as well as a lawyer, I am professionally tempted to simply substitute “efficient” for “optimal.” I shall try to avoid the temptation.

At the risk of succumbing, I shall start with efficiency as the first criterion to consider in comparing systems. Economists have several different meanings for “efficiency.” They most often like to invoke the concept of Pareto optimality, as it requires less tricky ethical defense than the main alternative, Kaldor-Hicks efficiency.⁴¹ Alas, in a comparison of entire national corporate governance regimes, Pareto optimality is of little use—almost certainly, some parties are better off in one system and other parties better off in the other. Kaldor-Hicks will have to do.

In considering efficiency in this sense, we must consider which system better solves the various agency problems created by the corporate form while also realizing the gains in managing a large enterprise which that form provides. Agency problems arise at all levels of a corporation: directors may not act in the best interests of shareholders (and perhaps other stakeholder groups, depending on where one stands in the shareholder-stakeholder debate);⁴² officers may not act as directors would like them to; employees may not act as the managers supervising them would prefer. There is much debate over how well the competing corporate governance systems deal with these agency problems.⁴³ The different systems also solve the team production and coordination problems a large organization faces differently.⁴⁴ Other concerns also affect the efficiency of a sys-

41. One distribution is Pareto superior to another if in the superior distribution there is at least one person who is better off and no person worse off. A distribution is Pareto optimal if no distribution is Pareto superior to it. A change from one distribution to another is Kaldor-Hicks efficient if it is possible to compensate anyone made worse off by the change so that after such compensation the resulting distribution would be Pareto superior to the original. The key difference is that under Kaldor-Hicks no compensation need actually be made, so that some persons may actually be worse off in the more efficient distribution. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 12–17 (5th ed. 1998) (describing gap between Kaldor-Hicks and Pareto measures).

42. This debate concerns whether corporate decisions should be made to benefit only the interests of their shareholders, or whether the interests of other groups (or “stakeholders”), such as employees, creditors, customers and suppliers, should be promoted as well, even when in conflict with the interests of shareholders. For a useful collection of related articles, see *Symposium: Corporate Malaise*, *supra* note 8, at 23-252 (presenting various articles on stakeholder and shareholder rights).

43. For a discussion of P1 and P2, see *infra* note 53-104 and accompanying text.

44. See *infra* notes 59 and 96 and accompanying text. By team production and coordination problems, I refer to the fact that corporations involve a large number of participants who must work together. In doing this work, they must all make a myriad of decisions, and they must coordinate those decisions and the actions that result.

tem of corporate governance as well. For instance, different systems may impose different levels of risk on participants.⁴⁵ In addition, systems may differ in how well they encourage long-run technological innovation.⁴⁶

Other values matter besides efficiency. Distributional equity is one major competing value, although of course there is much argument over what constitutes distributional equity. Many see equity as arguing for increased equality of income and wealth;⁴⁷ others find increased equality an unappealing goal.⁴⁸ Equity may conflict with efficiency; for instance, it is quite possible that the American system is more efficient but results in greater inequality. If so, we face a tradeoff.⁴⁹

45. For instance, shareholders of a corporation are exposed to more risk than depositors in a bank.

46. For instance, supporters of the American system point to the innovation coming out of Silicon Valley, and argue that the venture capital system which supports it depends on a strong equity market which supports initial public offerings. See Ronald J. Gilson & Bernard Black, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 47, 48-53 (1998) (suggesting that ability to divulge shares encourages investment).

To further complicate matters, one should distinguish efficiency comparisons of entire systems versus comparisons of just one piece within a system. For the latter comparison, one faces a second-best problem: an institution may be the first-best way of doing things within an overall efficient system, but may not be best given an overall inefficient system. See *infra* note 75 and accompanying text. To complicate matters even more, note that the corporate governance system as a whole is in turn just one piece of a larger economic system, and second-best considerations may therefore apply to the corporate governance system as a whole. For instance, Mark Roe has argued that within an economy where product markets are not competitive, a corporate governance system that encourages aggressive maximization of shareholder value may be sub-optimal, as it will lead to worse monopoly effects. This may be a reason why the Japanese and German system may be better in those countries, where product markets are often not competitive, while a more shareholder-focused system is better in the United States with its competitive product markets. See Mark J. Roe, *Rents and Their Corporate Consequences*, 53 STAN. L. REV. 1463, 1465 (2001) (discussing how extent of competition can affect governance structure appropriateness).

47. The modern classic is JOHN RAWLS, *A THEORY OF JUSTICE* (1971).

48. See ROBERT NOZICK, *ANARCHY, STATE, AND UTOPIA* 232-33 (1974) (noting that some legitimate processes might yield inequality of material conditions).

49. A standard argument is that equity should be pursued through taxation and transfer policies, which distort incentives less. See Louis Kaplow & Steven Shavell, *Should Legal Rules Favor the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income*, 29 J. LEGAL STUD. 821, 834-35 (2000) (defending view that tax system can achieve redistribution more efficiently); Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667, 677 (1994) (concluding that redistribution is more efficiently achieved through tax systems rather than legal rules). Recently, however, Chris Sanchirico has voiced some important objections to this position. See CHRIS WILLIAM SANCHIRICO, *INEQUITY AND DISTORTION: THE CONTINUING DEBATE ON EQUITY AND EFFICIENCY IN THE LAW (A COUNTER-RESPONSE TO PROFESSORS KAPLOW AND SHAVELL)* 7-23 (University of Virginia Law School Law-Economics Research, Working Paper No. 00-19, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=241573 (responding to arguments in favor of dealing with inequality through tax policy, while seeking only efficiency in legal rules); Chris William Sanchirico, *Taxes Versus Legal Rules As Instruments for Equity: A More Equita-*

A final criterion considered at points in this Article is the value of participation. Corporate governance systems certainly affect the level of participation in decision-making by various groups within the corporation, and they may have an indirect effect on the ability of groups to participate effectively in the political system as well. Participation may be an important value both within firms as well as within political institutions. Participation in making decisions, which importantly affect one's life, may be considered important in itself,⁵⁰ and may also make participants psychologically more fulfilled.⁵¹ Greater participation at work also may increase democratic skills and norms, thereby strengthening political participation.⁵²

I thus consider three different criteria—efficiency, distributional equity and participation—in asking which of the two corporate governance systems are superior. I do not attempt here to give a relative weight to these criteria, so to the extent that they conflict in their judgments, such conflict leaves a degree of indeterminacy in one's comparison of the systems. Different observers will weight these criteria differently. One possibility is that most Americans would weight the criteria such that the American system is preferred, while most Germans and Japanese would do the reverse. To the extent that different criteria point in different directions, we ultimately need to develop systematic arguments focusing on the weight of different criteria. As a professional economist and an amateur philosopher (at best), for here the most I can contribute is some sense of what economics can tell us about how well the two systems function according to the different criteria, leaving the weighting of those criteria to other work. Note that other empirical disciplines, especially sociology, may have much to say about how well the two systems function under the various criteria, especially equity and participation, but for here, I largely ignore such non-economic evidence. Again, in doing so I can only plead my personal comparative advantage in using economics.

I now turn to describing four stories about how the systems of corporate governance in the United States, Japan and Germany have gotten to where they are today and their relative desirability as measured by the criteria just discussed.

ble View, 29 J. LEGAL STUD. 797, 804-05 (2000) (arguing that legal rules ought to always be factor in redistribution policies).

50. See, e.g., ROBERT A. DAHL, A PREFACE TO ECONOMIC DEMOCRACY 111-35 (1985) (arguing in favor of democratizing economic institutions).

51. See, e.g., Jon Elster, *Self-Realisation in Work and Politics: The Marxist Conception of the Good Life*, in ALTERNATIVES TO CAPITALISM 127 (Jon Elster & Karl Ove Moene eds., 1989) (discussing arguments in favor of capitalism).

52. See, e.g., CAROLE PATEMAN, PARTICIPATION AND DEMOCRATIC THEORY 45-66 (1970) (discussing relationship between participation in workplaces and participation in wider political sphere); SAMUEL BOWLES & HERBERT GINTIS, DEMOCRACY AND CAPITALISM 131-35 (1986) (discussing anti-democratic effects of capitalist structure of production upon individuals).

A. *PI: The United States Has Evolved Optimally;
Japan and Germany Have Not*

I must explain several parts to this story. First, I canvas reasons why, given the relevant standard of optimality, the American system may be preferable to that of Japan and Germany. Second, I shall look at reasons why Japan and Germany may have failed to find the best path.

According to this story, the American system best balances disciplining managers and coordinating decisions with providing diversification and liquidity to investors. Broad and diversified American financial markets allow investors to construct portfolios which suit their individual needs.⁵³ Dispersed shareholding does create collective action problems in monitoring managers. An active market for corporate control, however, acts as a major deterrent against managerial misbehavior.⁵⁴ In addition, an active external labor market for high-level corporate managers gives managers a juicy carrot encouraging them to perform well.⁵⁵ Competitive product markets⁵⁶ and the threat of shareholder suits⁵⁷ present large sticks threatening miscreant corporate managers. Independent boards of directors are increasingly invoked as an active monitoring mechanism.⁵⁸ American corporations tend to have more centralized, hierarchical deci-

53. The importance of diversification in assembling an investment portfolio is a core principle of modern finance theory. See RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 149-56 (5th ed. 1996) (discussing relationship of risk and return in building portfolios).

54. See EASTERBROOK & FISCHER, *supra* note 9, at 162-211 (discussing tender offers as corporate control transactions).

55. See Fama, *supra* note 10, at 292-95 (discussing how pressure from managerial labor markets disciplines managers).

56. See Oliver D. Hart, *The Market Mechanism as an Incentive Scheme*, 14 BELL J. ECON. 366, 381 (1983) (concluding that competitive product markets can reduce managerial slack in economy).

57. At least until 1994, shareholder derivative actions in Japan were less legally favored than in the United States and rare. See Mark D. West, *The Pricing of Shareholder Derivative Actions in Japan and the United States*, 88 NW. U. L. REV. 1436, 1437-38 (1994) (noting relative rarity of derivative litigation in Japanese corporate landscape).

58. See Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1318 (1998) (noting strong relationship between active board monitoring and corporate economic performance). Many organizations and companies have in recent years produced corporate governance guidelines that frequently focus on active board monitoring. For full text copies of many of these guidelines, see generally European Corporate Governance Network, *Corporate Governance Codes, Principles, Recommendations and Laws*, at <http://www.ecgn.ulb.ac.be/ecgn/codes.htm> (last visited Nov. 8, 2001) (providing copies of, and links to, various corporate guidelines). But see Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. L. 921, 940-50 (1999) (surveying empirical evidence on board composition and finding no clear evidence for better performance by firms with majority-independent boards).

sion-making than Japan. This may make them more able to make large, rapid changes.⁵⁹

All of these mechanisms are weaker to non-existent in Japan and Germany. Japanese and German banks depend on their relations with a relatively small number of firms, perhaps making them under-diversified.⁶⁰ Until recently, at least, extensive cross-shareholdings and widespread norms have ensured that hostile takeovers virtually never happen.⁶¹ The external labor market is much less active,⁶² and product markets are less competitive.⁶³ Shareholders suits also are much less common.⁶⁴ It is claimed as a compensating benefit that Japanese and German banks actively monitor the performance of managers.⁶⁵ There is debate, however, over whether that actually happens.⁶⁶ Even if it does, banks may not encourage behavior in the best interests of shareholders, since as debtholders banks have incentives to prefer too little risk-taking.⁶⁷ Moreover, banks or other large shareholders may tend to prefer their own interests to those of small shareholders.⁶⁸ Perhaps most seriously, Japanese and German banks may not have the proper incentive to shut down poorly performing companies, leading to a soft budget constraint where corpo-

59. See David Charny, *Workers and Corporate Governance: The Role of Political Culture*, in EMPLOYEES AND CORPORATE GOVERNANCE, *supra* note 31, at 91, 111-12 (noting greater responsiveness and flexibility of American system of corporate governance).

60. See Macey & Miller, *supra* note 29, at 81-89 (discussing Japanese system of main banks and German system of universal banks). But note: even if the banks are under-diversified, the underlying depositors in those banks are probably subject to less risk than individual investors in American capital markets. However, the possible lack of diversification may create dangers for the financial soundness of the Japanese banking system.

61. See Julian Franks & Colin Mayer, *Bank Control, Takeovers, and Corporate Governance in Germany*, in COMPARATIVE CORPORATE GOVERNANCE, *supra* note 7, at 641, 642 (noting scarcity of hostile takeovers); Paul Sheard, *The Main Bank System and Corporate Monitoring and Control in Japan*, 3 JAPANESE BUSINESS 120, 129 (Schon Beechler & Kristin Stucker eds., 1998) (stating that corporate takeovers are "unheard of" in Japan).

62. See Gilson & Roe, *supra* note 31, at 258 (noting that closed labor markets complement Japan's lifetime employment system).

63. See Roe, *supra* note 46, at 1493 (noting that weaker shareholder primacy norms are present in nations with weak product markets).

64. See West, *supra* note 57, at 1437-38 (noting rarity of shareholder derivative actions in Japan). But see *Japan's Corporate Governance U-Turn*, ECONOMIST, Nov. 18, 2000, at 73 (providing information that states derivative suits have grown in Japan to about 200 per year).

65. See, e.g., Wenger & Kaserer, *supra* note 12, at 499, 511 (discussing pecuniary incentives for management).

66. See *id.*

67. See EASTERBROOK & FISCHER, *supra* note 9, at 68 (noting that debtholder with fixed claim on income stream has little to gain from borrower's pursuit of new projects).

68. For a discussion on behavior of banks in monitoring corporate governance, see *supra* notes 28-31 and accompanying text.

rate failure is not punished.⁶⁹ Many observers think this may be an important contributing factor to the decade-long under-performance of the Japanese economy. Japanese boards tend to be awkwardly large and filled with insiders, while German supervisory boards are limited in their effectiveness due to conflicts between shareholder and employee representatives.⁷⁰ The more decentralized and consensual decision-making of Japanese corporations may have limited their ability to rapidly adapt to new market conditions in the nineties.⁷¹

As for distributional equity, if one values equality it is somewhat hard to make the case that the American system tends to create more equality than in Japan or Germany. The gap between wages of top managers and ordinary employees tends to be much higher in the United States. One might argue that the extremeness of this gap is a relatively recent phenomenon, due largely to the growing use of stock options, which is not necessarily inherent to the American system. Nevertheless, while one could so argue, it would be hard to do with a straight face. One might instead try to argue that the American system justly rewards talent, risk-taking and hard work, and in doing so is fairer than its competitors. In part there is thus a conflict over preferred visions of distributive equity in comparing the two systems, although there is also some argument as to the extent to which the American system may value luck and social breeding rather than the qualities just mentioned.

With respect to the value of participation, the American system encourages widespread involvement in capital market investment. American households invest far more of their wealth in shares than do Japanese or German households.⁷² The regulation of capital markets in the United States is probably quite a bit more responsive to the desires of small investors than is the regulation of capital markets or banks in Japan and Germany. Although American firms in general appear to give employees less of a role in corporate decision-making than in Japan or Germany, it is easier for entrepreneurial individuals in the United States to start up their own companies.⁷³

69. See Brett H. McDonnell, *Banks, Worker-Controlled Firms, and the Soft Budget Constraint*, in *LABOR MANAGED FIRMS AND BANKS* (1994) (unpublished Ph.D. dissertation, Stanford University) (on file with the Stanford University Library).

70. See Roe, *supra* note 31, at 203 (noting that weakness of German supervisory boards may be structurally linked to "codetermination" by employee board members).

71. See Charny, *supra* note 59, at 110-11 (noting problems encountered under Japanese corporate governance system when rapid adaptation is necessary).

72. See Wolfgang Gerke, *Market Failure in Venture Capital Markets for New Medium and Small Enterprises*, in *COMPARATIVE CORPORATE GOVERNANCE*, *supra* note 7, at 607, 612-14 (discussing distribution of share ownership).

73. See Thomas A. Smith, *Institutions and Entrepreneurs in American Corporate Finance*, 85 CAL. L. REV. 1, 58-60 (1997) (discussing role of entrepreneur in American corporate finance).

P1 adherents must explain why Japanese and German markets have not evolved optimally. After all, the standard approach in corporate law over the last few decades has assumed that market forces weed out poor approaches and create a strong evolutionary pressure toward adoption of optimal forms of corporate governance.⁷⁴ What has kept this from happening in Japan and Germany, on the P1 story? Here is our first encounter in this Article with system-theoretic explanations and the notion of path dependence, so I shall spend a little time here outlining those ideas, which are important in what follows. What I shall call system-theoretic explanations emphasize the way in which a variety of elements within the two different systems interact with each other. Each different internal element of a system complements and supports a variety of other elements. As a result, it is hard to change any one element of such a system without changing the others as well. However, it may not be within the power of any actor within the system to change all of the elements together. Indeed, it may not even be socially good to change just one part of a sub-optimal system, making that part resemble its counterpart in a better system, if other parts of the system are not simultaneously changed. Piecemeal change actually may make things worse. That is the lesson of the theory of the second best.⁷⁵ Therefore, once a country's institutions have developed the elements of one system, it may be very difficult to change to another system—the country has gotten “locked-in” to that system. There are thus multiple equilibriums—multiple systems that a country may follow. It is possible that one equilibrium or system may be superior to the others, and yet a country locked-in to an inferior system may not be able to switch to the superior one. Which equilibrium a country has arrived at will depend on the history it has followed in getting there—that is the core idea of path dependence.⁷⁶

74. See EASTERBROOK & FISCHER, *supra* note 9, at 13 (“The history of corporations has been that firms failing to adapt their governance structures are ground under by competition.”).

75. For an overview of the theory of the second best in the law and economics context, see generally *Symposium on Second-Best Theory and Law & Economics*, 73 CHI.-KENT L. REV. 1 (1998) (providing various views on second-best theory).

76. See Masahiko Aoki, *The Japanese Firm As a System of Attributes: A Survey and Research Agenda*, in THE JAPANESE FIRM: SOURCES OF COMPETITIVE STRENGTH 11, 27 (Masahiko Aoki & Ronald Dore eds., 1994) (noting that Japanese and Western firm may be on different equilibrium paths); W. Brian Arthur, *Self-Reinforcing Mechanisms in Economics*, in THE ECONOMY AS AN EVOLVING COMPLEX SYSTEM 9, 17-23 (Philip W. Anderson et al. eds., 1988) (discussing path dependence and its relation to allocation processes); Bebchuk & Roe, *supra* note 32, at 169 (concluding that corporate structures are likely to reflect structures from earlier times); William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference*, 38 COLUM. J. TRANSNAT'L L. 213, 219 (1999) (noting that interdependence of components within economic systems present barriers to adoption of components derived from foreign systems); Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CAL. L. REV. 479, 483-84 (1998) (describing “network effects” concept, under which utility derived from use of certain systems increases as more agents make use of them);

What are the sources of the inter-relationships among different elements of a system that may cause such path dependence? A variety have been offered and classified in various ways. I suggest four categories of system effects: politics and rent-seeking, structural relationships, informational effects, and values and norms.⁷⁷

Politics and rent-seeking are one source of system effects.⁷⁸ Inefficient laws may have kept Japan and Germany from the optimal pattern. In Germany, co-determination laws are not only undesirable in imposing labor representation on supervisory boards, but also may have discouraged the development of dispersed shareholding.⁷⁹ The argument is that dispersed shareholding may require strong board supervision to be effective, but co-determined boards are so conflict-ridden that they are generally ineffective.⁸⁰ Both Japan and Germany may lack strong corporate and securities laws that provide effective protection for minority shareholders—this is the theme of important recent empirical work by the gang of four economists.⁸¹ Although it would be efficient to change these laws, the interests of entrenched bank and firm managers may present a formidable obstacle to change. Rent-seeking may also occur within firms, as those who gain from the current system, especially corporate managers, do not have incentive to change their firm's structures even if such change would increase overall efficiency, and transaction costs may block the bargaining that could induce them to change.⁸²

Different parts of the corporate governance system are also structurally inter-related. Concentrated blockholders rely on being able to gain private benefits at the expense of other shareholders in order to induce them to bear monitoring costs, so active legal enforcement of fiduciary duties may not be consistent with the Japanese and German systems.⁸³ Main bank monitoring protects managers and employees of firms from

Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641, 644-46 (1996) (discussing path dependencies in corporate structures).

77. For a somewhat different but related categorization, see Bebchuk & Roe, *supra* note 32, at 137-39 (describing sources of path dependence).

78. "Rent-seeking" refers to when individuals devote resources to achieving or defending personal benefits that do not benefit society to the same extent that the individuals are benefited. For instance, if large shareholders in Germany benefit from weak securities laws that help them run corporations in ways that favor their interests at the expense of small shareholders, those large shareholders will lobby to prevent changes in the securities laws.

79. See Roe, *supra* note 31, at 199-202 (discussing German securities markets and public choice).

80. See *id.* at 194-95 (stating reasons why codetermination may undermine diffuse ownership of stock in German markets).

81. See generally La Porta et al., *Law and Finance*, *supra* note 35 (finding correlation between weak protections for investors and weak capital markets).

82. See Bebchuk & Roe, *supra* note 32, at 142 (noting that rent-seeking may cause structures that have become inefficient to remain in place).

83. See Bratton & McCahery, *supra* note 76, at 228 (noting that extraction of private benefits by blockholders may be facilitated by legal regimes with lax protection of minority shareholder rights).

the threat of takeovers, which could discourage the investment in firm-specific human capital that is critical to the Japanese system of decentralized decision-making.⁸⁴ The lack of an active external labor market in Japan encourages an active internal labor market, which may in turn aid the Japanese approach to internal decision-making.⁸⁵ Masahiko Aoki has laid out a variety of other possible such structural inter-connections.⁸⁶ A different kind of structural effect focuses on how corporate governance systems are in turn part of a larger economic system. An imperfect corporate governance system may be a second-best adaptation within the broader economic system. For instance, the weaker focus on shareholder maximization in Japan and Germany may be a good adaptation in the context of weak product market competition.⁸⁷

Information and learning are a third possible source of system effects. Investors, both banks and individuals in bond and stock markets, may be familiar with certain kinds of business organizations and hence more willing to fund such organizations, which in turn leads to more such organizations, thereby reinforcing the greater familiarity with them.⁸⁸ Business people are familiar with certain practices, and the experience of many in using those practices has helped improve their effectiveness, making untried alternatives a poor risk. Business schools teach methods and ideas appropriate for a country's dominant system. Lawyers, investment bankers, accountants and management consultants are all important carriers of established understandings about how businesses should be run. If one is willing to assert that individuals are not as boundlessly rational as economists usually assume, then the availability heuristic strengthens these informational effects. The availability heuristic asserts that, rather than using proper statistical inference from known information, individuals tend to focus on information that is readily available to them—that is, information that comes easily and vividly to mind.⁸⁹ Thus, even if persons are abstractly aware of other ways of doing business, they may be likely to give more credence to methods that they have actively experienced themselves.

84. See Aoki, *supra* note 76, at 25 (noting that main bank monitoring system avoids hostile takeovers, protecting workers from drastic restructuring).

85. See *id.* at 23-24 (discussing interconnectedness of weak external and strong internal labor markets with Japanese internal decision-making system).

86. See *id.* at 22-27 (discussing potential structural interactions).

87. For a discussion on negative effects of corporate governance models favoring less aggressive shareholder maximization in economies with weak product markets, see *supra* note 46 and accompanying text.

88. See generally Brett H. McDonnell, *Credit Markets, Learning, and Choice of Alternatives*, in LABOR MANAGED FIRMS AND BANKS, *supra* note 69 (stating that individuals' investment decisions are based on familiarity leading to never-ending cycle of familiarity driven investment).

89. See Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, in JUDGMENT UNDER UNCERTAINTY 3, 11 (Daniel Kahneman et al. eds., 1982) (explaining availability heuristic).

Values, norms, and culture represent a fourth source of system effects. One could divide these into broad values and narrow values. Broad values refer to values that extend well beyond the realm of corporate governance. For instance, Americans typically may be more individualistic than Japanese, which may help explain the difference between the systems.⁹⁰ Note that different corporate systems may in turn help reinforce cultural differences. Narrow values are values specific to corporate governance. For instance, Japanese and German business people and lawyers may have a norm against engaging in hostile takeovers.

Thus, Japan and Germany may have formed path-dependent systems. Banks, firms, financial markets, governmental bureaucracies and laws may have evolved together. Once in place, no one actor has an incentive to change the system. A new Japanese corporation could not follow an American-style entrepreneurial path, since the stock, bond or venture capital markets needed to fund such growth are not well developed. Firms hook up with main banks instead. Business people expect a certain way of doing things and adapt to those expectations. Laws help reinforce the system, and entrenched interests stop those laws from changing.⁹¹ The American system may require an individualism that does not flourish as well in Japan or Germany as it does in the United States. On this story, the United States is a path-dependent system as well. Nevertheless, the United States has managed to find a path superior to that on which Japan and Germany are stuck.

B. *P2: Japan and Germany Have Evolved Optimally;
the United States Has Not*

P2 pictures the Japanese and German systems as more efficient than the American system. P1 may overstate current problems in Japan. Japanese and German banks might have a stake in enough firms to be adequately diversified. The practice of lending to firms through bank syndicates may help diversify further.⁹² Though banks prefer that firms engage in too little risk, shareholders may prefer too much risk.⁹³ Furthermore, several factors may reduce this conflict. Japanese and German

90. See BRANSON, *supra* note 33, at 45 ("The U.S. model contemplates a significant role for highly individualistic behavior."); Licht, *supra* note 34, at 150 ("[A] nation's unique set of cultural values might indeed affect . . . development of that nation's laws in general and its corporate governance system in particular.").

91. Laws may be one part of this self-reinforcing pattern, but not as central as suggested by Mark Roe's political theory of corporate finance. Laws may be more effect than cause—laws fitting an American-style system have not developed because no constituencies push for such laws in Japan or Germany.

92. See Toshihiro Horiuchi, *The Effect of Firm Status on Banking Relationships and Loan Syndication*, in THE JAPANESE MAIN BANK SYSTEM, *supra* note 12, at 258, 258-59 (discussing loan syndication and relationship between banks and firms).

93. See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991) (analyzing possibility of insolvency effect on risk incentives).

banks own stock in the firms to which they lend.⁹⁴ Moreover, because banks earn rent by continuing in a long-term relationship with a firm, they may desire that the firm expand, requiring risky investments, thus increasing their future rent from the firm.⁹⁵ The more decentralized and consensual decision-making of Japanese firms may allow them to use much useful information known by their employees, information that American firms typically ignore.⁹⁶

The American system also may be weaker than P1 adherents believe. Takeover, actual or threatened, may only discipline the most ill-behaved of managers, particularly now that managers know how to put in place effective anti-takeover defenses. Japanese and German banks may intervene earlier, before a firm's troubles have become extremely serious.⁹⁷ Even in the United States, hostile takeovers were rare before the 1960s, suggesting they are not so critical a disciplinary mechanism. The external managerial labor market is also imperfect—often outsiders cannot tell whether a firm's performance, good or bad, is due to its managers or other causes. The positive effects of independent boards of directors on firm performance are at this point quite unproven.⁹⁸

Just as much American hand wringing in the 1980s may have given undue weight to temporary, cyclical strong performance in Japan, American triumphalism today may put too much emphasis on differences that are in part cyclical. Japan's recent poor performance may not reflect deep structural differences in corporate governance, but more simply some macroeconomic policy mistakes on the part of Japan's central bank.⁹⁹ In other words, the main difference between Japan and the United States in the 1990s may have been Alan Greenspan.

American successes may be in other sectors where a different corporate governance regime prevails, not in sectors dominated by large public corporations. For instance, American success may be due in good part to high technology firms and the venture capitalist system.¹⁰⁰

94. See Aoki, *supra* note 7, at 14 (noting that Japanese banks are permitted to own stock in nonfinancial companies).

95. See McDonnell, *supra* note 69.

96. See Aoki, *supra* note 7, at 3-10 (discussing horizontal coordination and knowledge sharing among operational units in Japanese firms).

97. See Aoki, *supra* note 76, at 20-21 (discussing relationship of Japanese firm and main bank).

98. See Bhagat & Black, *supra* note 58, at 922 (noting lack of convincing evidence that corporations with majority independent boards out-perform other corporations).

99. See Bratton & McCahery, *supra* note 76, at 296 (noting that distress in Pacific markets may be tied to transient movements of stock market averages and business cycles).

100. However, there too the availability of the American stock markets as an exit strategy for investors may be crucial to the working of the system. See *supra* note 46.

Japanese and German corporations appear to create less inequality in pay between top managers and ordinary employees than their American counterparts. Thus, those who favor an egalitarian distribution of income and wealth have a reason to oppose the American system. Indeed, even many in Japan and Germany who think that American-style corporate governance leads to improved efficiency and productivity are somewhat wary of importing the American system unless it can be made to generate less inequality.¹⁰¹

Japanese and German corporations may encourage more employee involvement in internal decision-making than American corporations. In Germany, employee involvement is legally required through co-determination and works councils.¹⁰² Japan has no such laws, but Japanese managers take greater account of employee interests than American managers do, and Japanese employees may be actively involved in decisions at the shop level through innovations such as quality circles.¹⁰³

If the American system is indeed inferior, one must explain why it has lasted. Again, system effects may explain this. Political effects are a part of it. Mark Roe has pointed to the Glass-Steagall Act, the National Bank Act of 1864 and the failure to renew the charter of the Second Bank of the United States as having shaped the American system.¹⁰⁴ There may also be structural effects. For instance, American start-up firms do not have Japanese or German-style banks with which to form relationships, and so turn at a relatively early stage to external markets for financing. Banks that might want to follow the Japanese or German style, in turn, find it hard to get started on this path in competition with the bond and stock markets. The same informational effects as described under P1 would apply here. Value effects appear as well, as American individualism may discourage the degree of cooperation and egalitarianism required under the Japanese and German system.

C. *P3: The United States Has Taken a Different Path Than Japan and Germany, But Neither Path Is Clearly Superior*

Perhaps labeling an entire national system of corporate finance and governance as superior is an overly complex, if not nonsensical, task. The

101. See, e.g., David Wessel, *Us vs. Them: American Economy Offers a Model Others Both Envy and Fear*, WALL ST. J., Jan. 18, 2001, at A1 (noting global ambivalence toward adoption of American-style economic systems).

102. See Elmar Gerum & Helmut Wagner, *Economics of Labor Co-Determination in View of Corporate Governance*, in *COMPARATIVE CORPORATE GOVERNANCE*, *supra* note 7, 341, 341 (discussing question of co-determination and employees).

103. See Aoki, *supra* note 7, at 8 (noting superior utilization of on-site information to realize organizational goals in Japanese firms).

104. See ROE, *supra* note 28, at 21-49 (discussing impact of political forces on development of modern American corporate form).

American, Japanese and German systems all work well. Each has strengths and weaknesses, some of which P1 and P2 set out.¹⁰⁵

Even looking at each of our three values (efficiency, distributional equity and participation) separately, comparisons may be hard. How does one make Kaldor-Hicks efficiency comparisons when the two systems differ on such a variety of points, and where the American system has some advantages and the Japanese and German system has different advantages?¹⁰⁶ Simply comparing national Gross National Product (GNP) levels will not do, as there are a host of other differences between the countries that may swamp the effects of differences in corporate governance. Moreover, GNP is a notoriously imperfect measure of national well-being in any case.¹⁰⁷

In making comparisons with respect to equity and participation, there are problems both in determining the factual effect of corporate governance systems on these values and in determining what outcomes are best under these values. Does equity favor greater equality, or rather does it favor compensation based on talent and hard work? Does greater participation suggest we should focus on equal participation within large organizations, such as corporations, as Germany and Japan arguably achieve? Or, should we focus on allowing people to more easily create competing organizations, a virtue of the American system?

Furthermore, the recognition of a variety of values creates the possibility that these may point in different ways. For instance, perhaps efficiency favors the American system, while equity and participation favor Japan and Germany. We may find it hard then to say that either system is clearly superior. Those who care strongly about efficiency may favor the United States while those who care strongly about equality may favor Japan or Germany. To the extent that cultural values differ nationally and are in part endogenous to the systems, it may be that those raised in the American system find this system best. The same would hold true for those raised under Japanese or German values. This possibility may hold even though there is broad agreement on the facts of how the two systems compare along the various dimensions of interest.

Another possibility is that each system is best within its national context. For one thing, a corporate governance system is itself just part of a

105. For a summary of the effects of different governance systems on firm performance that reaches a mixed verdict, see generally MARIA MAHER & THOMAS ANDERSSON, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, CORPORATE GOVERNANCE: EFFECTS ON FIRM PERFORMANCE AND ECONOMIC GROWTH (1999), available at <http://www.oecd.org> (examining corporate governance systems and their implications in OECD countries).

106. See Bratton & McCahery, *supra* note 76, at 219 (noting that interdependencies among components within each system act as barrier to cross references between systems).

107. See, e.g., MARILYN WARING, IF WOMEN COUNTED: A NEW FEMINIST ECONOMICS 57 (1988) (noting that GNP fails to account for working conditions and some non-market activity).

broader economic system. The second-best arguments suggesting that changing just one part of an overall system may not be good may then apply to the corporate governance system as a whole.¹⁰⁸ More prosaically, each system may just be an optimal adaptation to the historical, resource, economic, political and cultural environment of the countries in which it is followed.

Under P3 one must still explain why the countries remain on separate paths. The same sorts of path-dependent mechanisms as suggested under P1 and P2 apply here. Perhaps path dependence arguments are rather stronger here, where no system is clearly superior so one might well expect less pressure for either system to move toward the other. If one thinks that each system is simply an optimal adaptation within the broader socioeconomic system of each country, then to explain the persistence of difference one would need to take a broader historical and social look at the differences between the countries.

D. *P4: The United States, Germany and Japan Are Roughly Similar*

The first three stories all assume that the American system differs fundamentally from that in Japan and Germany. Perhaps they do not. Perhaps instead their differences are mere variations on a theme. George Triantis and Ronald Daniels argue that banks play a bigger role in governing American firms than generally thought, suggesting much similarity with Japan.¹⁰⁹ Other institutional investors, such as pensions and mutual funds, to some extent in the American system, may also play the role of banks in the Japanese and German systems.¹¹⁰ Takeovers may not be such a big difference—though takeovers are less likely in Japan than the United States. Until the 1960s, they were rare in the United States as well, so perhaps they are not such a central part of the American system. On the other side, it is not as if stock and bond markets are totally undeveloped in Japan and Germany. Indeed, they are active relative to most of the rest of

108. For a discussion on second-best problems arising when comparisons are made based on one piece within a system, see *supra* note 46 and accompanying text.

109. See George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073, 1080-82 (1995) (discussing role of lenders within system of corporate governance).

110. In the early 1990s, there was much discussion about whether American institutional investors might be becoming, or able to become, more actively involved in corporate governance. See, e.g., Bernard Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 529-30 (1990) (recognizing role of institutions in shareholder voting); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1279 (1991) (noting that American organizational form has evolved to resemble German or Japanese industrial system); Edmund B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 447-53 (1991) (discussing role of institutional investors in corporate governance).

the world.¹¹¹ It is possible that the countries may differ significantly in formal legal rules, but in function, the systems work quite similarly. Sectoral differences within countries may be greater than differences between countries. For example, an American venture capital startup is governed far differently than an American large, long-established public corporation.¹¹²

A variant of P4 holds that the three countries are on the same path, but that Japan and Germany lag behind the United States on that path. On this view, shareholder protections in Japan and Germany lag behind those in the United States, so their stock markets are not as well-developed; however, they are moving in the United States' direction, and doing so in a way that roughly resembles how stock markets developed in the United States itself.¹¹³ After all, in the nineteenth and early twentieth century, the United States was characterized by more concentrated shareholding than now with at least some role for powerful banks involved in corporate governance—think J.P. Morgan.¹¹⁴

These four stories are ideal types. Reality involves some blend of them. Japanese, German and American firms are more or less alike in some ways, and more or less different in others. In some ways, American firms perform better, and in other ways, Japanese and German firms do a better job. Theory is clear; life is a muddle.

IV. FOUR STORIES OF THE FUTURE

In this section, I present four stories as to where corporations in Japan, Germany and the United States may be headed in the future. Again, the stories are ideal types. In this section, I do not explore the connection between these four future stories and the four past stories presented in the previous section; I save that task for the next section.

A. *F1: Japan and Germany Will Move Toward the Path Currently Followed by the United States*

Perhaps Japan and Germany will come to resemble the American system. There are signs of such change. The change could involve changing laws or creating new institutional patterns. John Coffee calls the former

111. For a discussion on behavior of the banking industry's role in monitoring corporate governance, see *supra* note 67 and accompanying text.

112. For an argument that this is becoming the case for employment practices, though it has not been so in the past, see HARRY C. KATZ & OWEN DARBISHIRE, *CONVERGING DIVERGENCES: WORLDWIDE CHANGES IN EMPLOYMENT SYSTEMS* 269-75 (2000) (noting sectional differences as major factor of within-country variation in employment systems).

113. See COFFEE, *supra* note 20, at 17-18 (noting similarities in evolution of American and German stock markets).

114. See *id.* at 31 (explaining that J.P. Morgan & Company Investment Bank held many directorships in nineteenth century businesses).

“formal convergence” and the latter “functional convergence.”¹¹⁵ Japanese firms increasingly use bonds, replacing bank loans.¹¹⁶ Though main banks often underwrite corporate bonds, using bonds rather than loans presumably weakens the banks’ influence. The pattern of cross-stockholding among firms and banks may also be loosening.¹¹⁷ In Germany, recent tax law changes are expected to dramatically reduce the shares of firms held or controlled by banks.¹¹⁸ Banking regulation reform in Japan is intended to make the functioning of banks more transparent and to address the soft budget constraint problem of banks failing to foreclose on bad loans.¹¹⁹ There has been some growth of venture capital financing and firms going public at a relatively young age in both Germany and Japan.¹²⁰ Organizations and companies in many countries, including Japan and Germany, have adopted corporate governance guidelines, which tend to focus on American-style active board monitoring.¹²¹

Note that F1 does not specify that the American system is superior to the opposing system. Thus, it is possible that P2 could be true—that is, that Japan and Germany have evolved optimally while the United States has not, and yet Japan and Germany will in the future come to resemble the American system. Section V will explore this and similar possibilities further.

B. *F2: The United States Will Move Toward the Path Currently Followed by Japan and Germany*

Perhaps instead the United States will come to resemble Japan and Germany. There are signs of this change too. The wall separating banking and commerce has crumbled dramatically. Large pieces of the Glass-Steagall Act have been eliminated, although the prohibition on commer-

115. See *id.* at 4 (defining “formal convergence” as “convergence to common legal rules and practices”).

116. See Masahiko Aoki, *Monitoring Characteristics of the Main Bank System: An Analytical and Developmental View*, in *THE JAPANESE MAIN BANK SYSTEM*, *supra* note 12, at 108, 135 (noting that “firms have come increasingly to rely on bond issues, at home and abroad”).

117. See *Ever So Polite: Japan’s Polite Corporate Raiders*, *ECONOMIST*, Feb. 17, 2001, at 63-64 (recognizing shift in Japanese corporate culture toward increasingly hostile takeovers).

118. See Matthew Valencia, *Cross About Holdings: Europe’s Ownership Structures Are Being Re-examined*, *ECONOMIST*, Apr. 29, 2000, at 52 (noting that elimination of punishing capital gains tax will lead to replacement of institutional shareholders with active individual investors).

119. See *Seriously?*, *ECONOMIST*, Feb. 24, 2001, at 78 (noting that foreclosure and bad loans will lead to “painful reform”).

120. See *Panik? Germans Still Love Shares*, *ECONOMIST*, Oct. 28, 2000, at 72 (noting that German investors are still providing financing even though initial public offerings and “high profile share issues” have decreased).

121. See *supra* note 58 and *infra* note 177.

cial banks owning stock remains in a weakened form.¹²² Many American firms have taken on a debt-equity ratio resembling that of Japanese and German firms. Michael Jensen argues that leveraged buyouts have created a corporate form resembling that of Japan.¹²³ Institutional investors, such as pensions and mutual funds, may come to take the active monitoring role of banks in the Japanese and German system.¹²⁴ As with F1, the change may involve formal or functional convergence.

C. *F3: The United States, Japan and Germany Will Converge to a Hybrid Form*

F1 noted signs of Japanese and German firms moving towards an American pattern; F2 noted signs of the reverse. Maybe they will meet in the middle.¹²⁵ The increasing internationalization of corporate finance might lead people in each country to copy the others' best practices.¹²⁶ A hybrid system might combine the advantages of both systems. Of course, it might combine the disadvantages of both systems too. Another possibility is that each country will contain firms that follow different sorts of governance practices.¹²⁷

F3 must contend with the theory that the two corporate governance systems are complex systems of inter-dependent parts and organizations, which have adapted to fit each other. Changing one part may be hard to do without changing other parts as well.¹²⁸ A hybrid may not be possible,

122. See Randall S. Kroszner, *The Legacy of the Separation of Banking and Commerce Continues in Gramm-Leach-Bliley*, REGION, ¶¶ 2-4 (June 2000), at <http://minneapolisfed.org/pubs/region/00-06/kroszner.html> (last visited Jan. 7, 2002) (arguing that Gramm-Leach-Bliley Financial Modernization Act of 1999 has not eliminated all restrictions against banks from investing in nonfinancial enterprises).

123. See Jensen, *supra* note 27, at 61 (arguing that takeovers, corporate break-ups and leveraged buyouts, among other things, display organizational change in economy).

124. For a further discussion of this possibility, see sources cited *supra* note 110.

125. Aoki suggests this as one possibility. See Aoki, *supra* note 76, at 33-36 (noting different scenarios regarding convergence of Japanese and Western corporate governance systems).

126. There is a rather extensive business school literature on international best practices and how corporations are looking to and adopting the best practices of corporations from around the world in a number of areas of management. For some recent work on this question, see Michael R. Czinkota & Ilkka A. Ronkainen, *Globalization: An Introduction and Assessment of Realities and Strategies*, in BEST PRACTICES IN INTERNATIONAL BUSINESS 1, 2 (Michael R. Czinkota & Ilkka A. Rankainen eds., 2001) (noting that international customers are demanding products that draw from worldwide best practices).

127. See KATZ & DARBISHIRE, *supra* note 112, at 265 (noting that different economic pressures across countries and industries lead to employment system variation).

128. See Bratton & McCahery, *supra* note 76, at 220 (stating that changing incentive patterns could destabilize working arrangements). Aoki also suggests this as a possibility. See Aoki, *supra* note 76, at 16 (describing rank hierarchy in

or it may be very unattractive. I will deal with this possibility further in the next section.

D. *F4: The United States Might Remain, or Become, Distinct from Japan and Germany*

Perhaps whatever has kept the two systems distinct to date, assuming they are distinct, will continue to keep them distinct in the future. Although F1 and F2 point to signs of change, those changes may not go far. Perhaps the economy is not becoming all that global after all. In many ways the nineteenth century's economy was as global as today's economy. Law may prevent convergence. Or, path-dependent features of complex systems now adapted to certain forms may prevent change and convergence.¹²⁹

Indeed, certain features, which have historically been similar, may diverge. A recent study of corporate law provisions in the United States and Japan suggests that such divergence has indeed occurred over the past few decades for some provisions.¹³⁰

For convenience, I summarize P1 through P4 and F1 through F4 in Table 1.

V. RELATING PAST AND FUTURE STORIES

Section III set out four stories of how the two systems of corporate governance came to evolve to their current states. Section IV set out four stories of where the systems of corporate governance may be headed. Conceivably, each past story could be combined with each one of the future stories, leading to sixteen different possible combinations. These combinations are set out in Table 2.¹³¹ This section will explore the different possibilities. It will consider in more depth the possible mechanisms of evolution that may guide corporate governance systems. Although in the end I tentatively advance which combination I think is most likely, the main point is that there are a wide variety of possibilities, and at this point neither theory nor empirical evidence gives persuasive reason to rule out any of the possible combinations.

Japanese businesses). For a detailed discussion of corporate governance systems, see *supra* notes 80-96 and accompanying text.

129. See Aoki, *supra* note 76, at 35 (noting possibility that differences between Japanese and Western business models are problematical).

130. See MARK D. WEST, *THE PUZZLING DIVERGENCE OF CORPORATE LAW: EVIDENCE AND EXPLANATIONS FROM JAPAN AND THE UNITED STATES* 5 (University of Michigan Law School Law and Economics Research, Working Paper No. 00-011, 2000), available at http://papers.ssrn.com/paper.taf?abstract_id=251028 (describing recent divergence between United States Model Business Corporation Act and Japanese Commercial Code despite having base in same act).

131. By relying so prominently on a grid table such as Table 2, I hope to be doing my bit to promote inter-disciplinary work with sociology. I trust that using a 4x4 rather than a 2x2 table still fits within the spirit of that discipline.

TABLE 1: SUMMARY OF POSSIBLE STORIES

<i>Stories of the Past</i>	
P1	The United States has evolved optimally; Japan and Germany have not
P2	Japan and Germany have evolved optimally; the United States has not
P3	The United States has taken a different path than Japan and Germany, but neither path is clearly superior
P4	The United States, Germany and Japan are roughly similar
<i>Stories of the Future</i>	
F1	Japan and Germany will move toward the path currently followed by the United States
F2	The United States will move toward the path currently followed by Japan and Germany
F3	The United States, Japan and Germany will converge to a hybrid form
F4	The United States might remain, or become, distinct from Japan and Germany

I consider the sixteen combinations in turn.

A. P1 – F1

This is the dominant story of American triumphalist convergence.¹³² The discussion of P1 in Section III presented reasons to consider the American system superior. The arguments are most persuasive if one focuses on efficiency as a value. Over the last decade, American firms have tended to out-perform firms elsewhere in profitability, growth and innovation.¹³³ The role of venture capitalists in Silicon Valley makes a particularly strong case for American superiority in corporate governance and corporate finance (granted, this sentence is less compelling now than it would have been in January 2000).

Given P1, the argument for F1 draws on notions of evolution and globalization. In today's economy, large corporations must increasingly compete with each other for both capital and sales. Firms that are less efficiently organized will lose this competition.¹³⁴ As multinational firms, investment banks, management consultants and the like spread around

132. See Hansmann & Kraakman, *supra* note 1, at 468 (stating that standard corporate model is dominant legal model in every jurisdiction); see also GILSON, *supra* note 21, at 17 (noting that active venture capital market, typical of American system, has lead other countries to replicate its success); Coffee, *supra* note 20, at 642 (“[C]onventional governance norms in the United States may be more the product of a path dependant history than the ‘natural’ result of an inevitable evolution toward greater efficiency.”).

133. See A.K.N. Ahmed, *World Economic Scenario: A Critique of Models*, INDEPENDENT, Apr. 21, 2000, 2000 WL 6306630 (comparing United States, Germany and Japan in terms of growth, productivity and job creation over ten year period).

134. For a more detailed discussion of this standard story in contemporary corporate law scholarship, see *supra* note 74 and accompanying text.

TABLE 2: SUMMARY OF POSSIBLE OUTCOMES

	F1	F2	F3	F4
P1	American triumphalist convergence	Converge to inferior Japanese-German system	Superior American system and inferior Japanese-German system converge to hybrid	Inferior Japanese-German system remains on separate path
P2	Converge to inferior American system	Converge to superior Japanese-German system	Superior Japanese-German system and inferior American system converge to hybrid	Inferior American system remains on separate path
P3	Converge to American system though not clearly superior	Converge to Japanese-German system though not clearly superior	Two non-comparable systems converge to hybrid	Non-comparable systems remain on separate paths
P4	Japan and Germany, already on same path as the United States, catch up	Japan, Germany and the United States remain on same path	Japan, Germany and the United States remain on same path	Currently similar systems diverge or, United States stays ahead of others though on same path

the world, America's best practices can and will be learned and copied in other countries. Governments will increasingly feel forced to change laws that do not fit well with evolving institutions or else face the decline of their nation's largest businesses. Of course, such legal changes may lag behind other changes—to use Coffee's terminology, "functional convergence" may be quicker than "formal convergence."¹³⁵

There is some evidence of a move towards the American system. The discussion of F1 in Section IV briefly presents some of that evidence. A number of observers in Japan, Germany and other parts of Europe seem to believe that the American system has demonstrated such strength over the past decade that their countries must follow the American lead or else fall further behind.¹³⁶ The convergence thesis suggests that this trend will continue.¹³⁷

135. See Coffee, *supra* note 20, at 657 (stating possibility that "functional convergence" may trump "formal convergence").

136. See Lydia Lim, *Japan Must Restructure to Compete*, STRAITS TIMES, Feb. 16, 2000, 2000 WL 2965472 (claiming that Germany and Japan will have to change methods of investing capital and labor and delivery services to compete with United States).

137. See Hansmann & Kraakman, *supra* note 1, at 455 (suggesting that weaker economic systems will continue to converge to American system).

B. P1 – F2

This combination looks odd. It maintains that the United States has followed a path superior to that of Japan and Germany, but nonetheless that the United States will converge to that other, inferior path. How could that happen?

We have already considered system-theoretic stories about how corporate governance systems may come to follow non-optimal paths.¹³⁸ What happens when two such systems come to confront each other in international competition? No one really knows, but it is not necessarily clear that the superior system must win. At issue is the relative strength of the system mechanisms described above versus the strength of forces favoring the selection of a superior system and the direction of those selective forces. Selective forces need not necessarily select the best system overall. For instance, one system may possess properties that are not socially superior but that help firms using that system to thrive in competition with other firms. Many characterized Japanese firms in the 1970s and 1980s as ignoring the needs of shareholders and focusing on market share.¹³⁹ Such an approach may be inefficient, but firms following such an approach may for a long time gain market share over firms following a more shareholder-friendly path. If this process is strong and fast enough, perhaps American firms might be forced to follow the Japanese model or else go under. There seems little prospect of this now, but it seemed possible, indeed probable to some, in the late 1980s, and it is conceivable that tides could shift again.

Another possibility draws on the systemic effects of informational forces considered above. Perhaps parties (both firms and investors) in the competing systems are comparing and contrasting the approaches and choosing the approach that appears superior. Although this might suggest that the superior system should win out, it is not necessarily so. If the inferior system has a run of good luck and the superior system a run of bad luck, the inferior system might come to appear superior. Parties might then shift to adopting the inferior system, until the superior system drifts towards oblivion. Some think that this sort of story is important in the adoption of competing technologies; perhaps it could happen in the adoption of competing systems of corporate governance as well.¹⁴⁰ If the United States is superior and Japan and Germany are inferior this does

138. For a discussion of corporate governance systems, see *supra* notes 80-87 and accompanying text.

139. See Dan Fenko Henderson, *Security Markets in the United States and Japan: Distinctive Aspects Molded by Cultural, Social, Economic and Political Differences*, 14 *HASTINGS INT'L & COMP. L. REV.* 263, 281 (noting that Japanese corporations pay more attention to market share than shareholders).

140. See W. Brian Arthur & David Lane, *Information Contagion*, 4 *STRUCTURAL CHANGE AND ECONOMIC DYNAMICS* 81 (1993) (noting that investors will tend to favor those ideas and systems that have readily available information and are widely discussed). See generally Robin Cowan, *Tortoises and Hares: Choice Among Technologies of Unknown Merit*, 101 *ECON. J.* 801 (1991) (discussing adoption process scenarios

not seem a particularly likely current scenario, but again it may have come close to happening in the eighties.

Another possibility leading to this scenario is that the political forces opposing change are stronger in Japan and Germany than in the United States. Those political forces could use the state to prevent American firms from entering Japanese or German markets and gaining an advantage there, while using governmental subsidies to help Japanese or German firms succeed in American markets. Again, this was a real fear for many Americans in the eighties, although it seems less plausible now.

C. *P1 - F3*

This possibility is something of a mix of the two just considered. According to it, the American system has evolved as the superior system, but it and its alternative shall converge to a hybrid system. This story has several possible variants.

On one variant, although the American system is overall superior, there may be specific features of the Japanese and German systems that are preferable to their American counterparts. An optimistic theory of evolution towards best practices may claim that each system, American, Japanese and German, will adapt to take on specific features of other systems that complement and enhance the current best practice system. For instance, American firms in the 1980s and 1990s to at least some extent, adapted Japanese just in time production techniques. American firms, to a limited extent, may have moved towards the heavier use of outsourcing, a typical practice of Japanese manufacturers.¹⁴¹

On another variant, the hybrid to which both systems are converging does not necessarily represent the optimal way of doing things for each element within the hybrid system. It may be that some elements of the corporate governance system are strongly enough inter-related that it is not possible or desirable to change one of those elements without changing the others as well.¹⁴² Some parts of the system, though, may be less inter-dependent and hence more adaptable in response to the practices of other systems. On this story, the United States may take some Japanese elements, such as just in time production, which turn out to be easily adaptable. The United States would retain other elements, such as relatively weak shareholder monitoring. While certain practices in theory might be undesirable, they are closely linked to other elements, such as active stock markets, which are in many other ways quite attractive. Japan and Germany, in turn, will change their systems more drastically in order

relating to technology). The triumph of VHS over Beta in the videotape market is a frequently cited example.

141. The literature on international best practices suggests such a process—indeed; it is itself part of such a process. *See supra* note 126.

142. The potential undesirability of piecemeal change in a sub-optimal system is a consequence of the theory of the second best. *See supra* note 75 and accompanying text.

to reach the hybrid system in an attempt to remain internationally competitive.

A more lurid possibility is that the systems will converge to a hybrid featuring the worst of both systems. International markets could undermine the needed disciplinary mechanisms of both systems. In Japan and Germany, banks lose influence as the best companies turn to international stock and bond markets.¹⁴³ In the United States, needed securities law protections are lost as companies engage in regulatory arbitrage to evade those securities laws. I doubt we are headed there, but we should not dismiss this possibility out of hand.

D. *PI - F4*

This story suggests that strong forces will keep the systems on separate paths.¹⁴⁴ Even though the system in Japan and Germany is inferior and doing poorly in international competition with the United States, it will persist. All four of the systems factors might cause this. Entrenched political interests may favor the present system and oppose changes required to move to the American system. There is certainly evidence of this today in Japan.¹⁴⁵ Many both in and outside of Japan believe that Japanese banks need to be reformed so that they stop propping up companies that deserve to die.¹⁴⁶ There have been some attempts to achieve such reform.¹⁴⁷ The attempts, however, have been relatively feeble, and the ruling party appears unable so far to overcome the political obstacles to reform.¹⁴⁸

There are structural reasons to expect that Japan and Germany will not come to look like a mirror image of the United States. It may be that many parts of the corporate governance system need to be changed more or less simultaneously in order to succeed. No one individual actor may have the ability or the incentive to direct all the changes that must be made, and coordinated change may be impractically costly. Moreover,

143. See generally Aoki, *supra* note 116 (comparing Japanese Main Bank System to other governance systems and questioning whether Japanese system possesses best practices).

144. In particular, it suggests that these forces are stronger than the forces pushing for evolution to an optimal system. See *supra* note 74 and accompanying text.

145. See Curtis J. Milhaupt, *A Relational Theory of Japanese Corporate Governance: Contract, Culture, and the Rule of Law*, 37 HARV. INT'L L.J. 3, 49 (1996) (claiming that unstable political system impedes regulatory reform).

146. See Dafei Chen, *Acute Symptoms of Chronic Problems: Japan's Procrastination in Solving Its Banking Crisis, the Current Situation and a Future Perspective*, 9 MINN. J. GLOBAL TRADE 269, 283-84 (2000) (noting that more regulation of banks' bad debt is needed).

147. See *id.* at 280-85 (discussing Japan's past, present and future attempts at banking reform).

148. See *id.* at 291 (claiming that Japan must be prepared to take politically painful steps to save economy).

changing corporate governance in its entirety may be sub-optimal if the rest of the economic system remains unchanged.

Informational effects may also be at work. Although with globalization and the Internet people in Japan and Germany are more aware of the American way of business than they were in the past, there are still significant differences in the knowledge and experiential base of people in the United States versus people in Japan and Germany. Linguistic differences may make those differences hard to overcome.¹⁴⁹

A final obstacle to convergence may be national differences in values and culture. Values and culture may be deep-seated enough that they are quite hard to change.¹⁵⁰ Moreover, basic values affect far more in society than corporate governance, and it may not be worth changing such values just because corporations might be better governed if citizens had different values. If value and cultural differences are crucial to the differences between systems, this factor alone may be enough to block convergence.¹⁵¹

E. P2 – F1

According to this story, Japan and Germany have evolved a system superior to that of the United States, and yet they will converge to the American system.¹⁵² It thus shares some of the facial oddness of P1 – F2,

149. The linguistic point may be stronger for Japan than it is for Germany.

150. See BRANSON, *supra* note 33, at 45 (analyzing cultural challenges to convergence in China and Indonesia); Licht, *supra* note 34, at 164 (noting that culture is strong impediment to change).

151. I am not inclined to put too much emphasis on values and culture in explaining the differences between the United States, Japan and Germany in corporate governance. For instance, the differences between the United States and Japan largely seem to have a modern origin, reflecting political choices in the years after World War II. See Aoki, *supra* note 7, at 2 (questioning importance of Japan's culture on management of its firms); Gilson & Roe, *supra* note 31, at 265-66 (discussing human capital requirements during post-World War II labor shortage and noting that United States had fixed wages and mobile jobs while Japan had fixed employment and variable wages). Nevertheless, value differences may well be more important in explaining differences between the United States and less developed countries.

152. Note that Hansmann and Kraakman consider the possibility that countries will converge to American practices which are in some ways non-optimal. They specifically point to international agreement as to limited liability for torts, which they attacked in an earlier article. See generally Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991) (discussing consequences of limited corporate tort liability). On that particular point, I share the skepticism that has met their argument. They also point to another way in which we may be converging to a non-optimal outcome, which way is more significant to this Article. They note that in some ways the American system may give too much unchecked power to managers, particularly in their ability to defend against hostile takeovers. They describe this as "a slight managerialist tilt." Hansmann & Kraakman, *supra* note 1, at 467. One could instead characterize Delaware takeover law as a full-fledged capitulation to managerial power.

discussed above. Some of the points made in that discussion apply here as well. For instance, in comparing systems one may appear superior for temporary reasons but come to dominate as parties adopt that system and become familiar with it. The current apparent efficiency of the American system may be a fad based on a long run of American good luck and Japanese bad luck with the business cycle. If Japan does succeed in fundamentally changing its system, it may find it hard to go back, so that temporary bad luck has permanent consequences.¹⁵³

There may also be features of the Japanese and German systems that make these systems vulnerable to competition with the American system even though the American system does not always work as well. For instance, it might be that banks require limits on competition from certain kinds of capital markets. An adverse selection process currently seems to be occurring (in the United States as well as Japan) whereby the best large corporations are turning to bond markets rather than banks for debt financing.¹⁵⁴ It could be that ultimately bond markets do a poorer job of monitoring corporate behavior, but the presence of such markets may nonetheless make it much harder for banks to do their jobs well. This is a possible argument for governments not encouraging some capital markets, as indeed may have been the case in Japan and Germany. Nevertheless, once markets in the United States become available to international corporations, effective regulation by national governments becomes quite difficult. Note how this possibility turns Coffee's argument on functional convergence on its head: international capital markets may indeed help encourage functional convergence, but the result is a race to the bottom, not the top.

Another possibility is that Japan and Germany are superior to the United States on non-efficiency-based grounds, but that (a possibly temporary) apparent American superiority in efficiency and productivity is stampeding Japan and Germany into a regrettable imitation of the United States. Ronald Dore takes a position along these lines, although he thinks there is hope that Japan, at least, will resist the American siren song.¹⁵⁵

F. P2 – F2

On this story, the Japanese-German system is superior and the American system will converge to it. The same forces of evolution and globaliza-

153. Of course, it is instead possible that the American run will end and perceptions will change before any permanent changes are made. Indeed, there are already some signs of changing perceptions.

154. See *A Survey of Corporate Finance*, *ECONOMIST*, Jan. 27, 2001, at 11, 20 (suggesting that effects on market due to technological advances may cause corporations to borrow more from bond market).

155. See RONALD DORE, *STOCK MARKET CAPITALISM: WELFARE CAPITALISM: JAPAN AND GERMANY VERSUS THE ANGLO-SAXONS* 221-39 (2000) (suggesting that Japan is more likely than Germany to combat adopting American ways because of its strong cultural ideals, "holistic" corporate thinking and its neighboring countries' practices).

tion discussed above under P1 – F1 are relevant here. The only difference is that on this story it is Japan and Germany, rather than the United States, which possess the superior system. The discussion of P2 in Section III above canvasses some reasons why the American system may be inferior.

In the 1980s and early 1990s, there was some evidence, and much speculation, that this story was occurring.¹⁵⁶ Japanese firms in particular seemed to be out-competing American firms in a number of areas, and many commentators noted that Japanese and German banks may do a better job of solving corporate agency and coordination problems than American capital markets do.¹⁵⁷ The story seems a bit quaint today, after a decade of Japanese travail and American triumph. One should not base conclusions as to the relative superiority or inferiority of corporate governance systems, however, on the evidence of just one decade. The 1980s may have been a fad, but then again, perhaps the 1990s were the fad and the 1980s were the real deal.

G. P2 – F3

This is similar to P1 – F3, described above, and like it, P2 – F3 has a couple of variants. In one, although the Japanese-German system is overall superior, the American system does have some good practices, and both are converging to a hybrid that combines the best practices of both. For instance, the current banking problem in Japan may be solvable by tougher, more American-style banking regulation and the government refusing to bail out troubled banks and companies.¹⁵⁸ If Japanese banks did not have overly-friendly regulators to fall back on they might be more likely to pull the plug on failed companies, causing the system to work better. It is hard to see many signs of the United States presently converging to much of the Japanese-German system, but again, that could be an accident of temporary American good luck.

The other variant of this story has the Japanese system adopting some American best practices that are not incompatible or undesirable within the context of the main Japanese system, but rejecting other American practices that, while perhaps desirable on their own, do not fit in the Japanese system. For instance, while hostile takeovers may be attractive as a disciplinary mechanism, they may be inconsistent with the degree of main bank control required to make the Japanese system work.

156. See, e.g., KATZ & DARBISHIRE, *supra* note 112, at 169 (proposing that Germany was more stable than other industrialized countries during 1980s).

157. See Roe, *supra* note 28, at 59-60 (remarking that Japanese and German banks are not only more heavily involved in commerce than American banks, but also control large amounts of stock and daily corporate affairs).

158. See Bebchuk & Roe, *supra* note 32 at 136-37 (examining breakdown of Japanese banking system in context of similarities and differences between corporate ownership and governance structures).

H. *P2 – F4*

As with P1 – F4 above, here an inferior system remains stuck on its path despite being in competition with a superior system. The only difference is that here the inferior system is that of the United States. The same sorts of mechanisms may block divergence, including interest group opposition, structural inter-relationships, culture and values. Mark Roe's work on the political origins of American corporate finance surveys some of the relevant political forces.¹⁵⁹

I. *P3 – F1*

In this square, neither system can clearly be said to be superior, but the Japanese-German system will nonetheless converge to the American. The factors discussed in P2 – F1 above are relevant here too in explaining this convergence. Beyond these, here there is another possible consideration. It could be that the two systems cannot be decisively compared in part due to conflicting values. The American system may be more efficient while the Japanese-German system creates greater equality and/or greater participation. Perhaps the evolutionary and competitive pressures towards convergence focus mainly on the relative efficiency of competing alternatives. If so, evolution may favor the American system because of its greater efficiency. Economic natural selection may ignore the values of equality and participation.

J. *P3 – F2*

In this case, neither system can clearly be said to be superior, but the American system will converge to that of its competitors. The factors discussed in P1 – F2 above are relevant here too in explaining this convergence. Beyond these, I suppose there is a conceivable consideration parallel to that just considered for convergence to the American system. Perhaps the pressures towards convergence could turn out to be political rather than economic and focus on the values of equality and participation rather than efficiency. If so, and if Japan and Germany excel in those political values, then convergence would favor their system. This story, though, would imply an American political revolt against the concentrated economic and political power of corporate managers. It is a logical possibility. Another possibility is that the American system is inferior in terms of efficiency, but superior in encouraging participation and in anti-egalitarian distributional values. Hence, economic evolutionary forces favor the more efficient Japanese and German system.

159. See Roe, *supra* note 28, at 31-53 (noting that all elements, such as American public opinion and ideology, interest group politics and American political institutions, combine to affect outcome of political story).

K. P3 – F3

This alternative maintains that the two systems cannot be clearly ranked, either because one does better with some values and the other does better with others, or because even when looking only at efficiency, both solve the problems corporations face more or less equally well. In the future, they will converge to a hybrid. The most important variant maintains that this hybrid will combine the best practices of the two different systems. In doing so, it suggests that the four kinds of system effects, which may give rise to path dependence, can be overcome. Perhaps informational effects have been particularly important—the two systems have remained different up until now in large part because the different parties in each system have become familiar with their own systems' ways of doing things. However, with growing globalization, economic actors can now learn from other countries, thereby overcoming the informational effects. Globalization may also reduce some structural impediments to change. Parties in one country can now more easily interact with and be supported by institutions in other countries. Banks and capital markets need not be incompatible alternatives. Indeed, in important ways, banks can benefit from access to sophisticated capital markets, and capital markets in turn work better with active, sophisticated banks serving as monitors and financial intermediaries.¹⁶⁰ Even political opposition to change may eventually melt away as it becomes clear that countries failing to adapt will lose their economic position in the world. Values too may be malleable, or they may not be important to the differences between corporate governance systems. The Japanese corporate system, for instance, seems to be largely a creation of the post-World War II era; the expression of ancient Asian values may not play as large a part in Japanese corporations.¹⁶¹ A variant of this position is that, although the United States has differed systematically from Japan and Germany in the past, we are moving to a future where the differences between firms within all three countries will be much greater than the differences between the countries overall.¹⁶²

L. P3 – F4

This scenario agrees with the starting point of the previous ones: the two systems cannot be clearly ranked. However, it maintains that the

160. See ALLEN & GALE, *supra* note 7, at 47-76 (comparing roles of banks and markets in different countries and influence these financial systems have on countries' economies).

161. See Aoki, *supra* note 7, at 14-17 (exploring birth and adaptation of Japanese financial structures); Gilson & Roe, *supra* note 31, at 251-54 (discussing how post-World War II political efforts shaped how labor and corporate governance institutions developed in Japan).

162. See KATZ & DARBISHIRE, *supra* note 112, at 270-72 (finding, for example, factors such as centralization by unions and employers' associations, commonality of decentralized processes and power and degree of effective coordination among actors all contribute to international variation among firms).

forces preventing the systems from changing dramatically are stronger than those pushing towards convergence. Concentrated shareholder, bank-centered monitoring may just not be consistent with dispersed shareholder, capital market-centered corporate governance.¹⁶³ The political resistance of entrenched interests in each system may be too strong to budge.¹⁶⁴ Deep-seated value differences may not be moved by the competition of corporate governance systems, and they may be important in explaining the persistence of different systems.¹⁶⁵ Informational differences may not be easily erased, even in our new global economy. It may also be that the competitive pressures creating a tendency to evolve to the best system may not be as strong as some suppose. For instance, pressure created by the need for external capital may be overstated, as most large firms rely mainly on retained earnings to finance most of their investment.

M. P4 – F1

P4, you may recall, maintains that the three countries are already on the same basic path. On one variant, there are already few fundamental differences between them. Given this starting point, it would seem natural to predict that the countries will remain similar in the future. None of the future stories articulated here fits particularly well with this story, as they appear to assume different starting points for the two systems. However, I assume this might be termed Japan and Germany moving toward the path currently followed by the United States, although it might just as well be called the United States moving toward the Japanese-German path or both moving toward a hybrid, in the sense that all these paths are the same, given P4.

Another variant of P4 states that the countries are on the same basic path, but the United States is further along on that path. On this variant, P4 – F1 can be read to state that Japan and Germany will eventually catch up to the United States. Thus, this is a version of the American triumphalist story; it is, however, a less interesting version in that it maintains that Japan and Germany never posed a real alternative to the United States in the first place. Coffee may fit this description.¹⁶⁶

163. See Bratton & McCahery, *supra* note 76, at 289-92 (arguing that concentrated shareholder and dispersed shareholder schemes are inconsistent on several levels).

164. See Bebchuk & Roe, *supra* note 32, at 142 (stating that changing ownership structure is difficult because controlling parties will try to impede change).

165. See BRANSON, *supra* note 33, at 6 (arguing there will never be global convergence because American capitalism and corporate governance will never change governmental and societal barriers); Licht, *supra* note 34, at 147 (stating that culture plays role in development of corporate governance systems).

166. See Coffee, *supra* note 20, at 646-48 (discussing variations in convergence theories).

N. *P4 – F2*

This scenario says the three countries are already on the same path, and that the United States will move to the path currently followed by Japan and Germany. As just stated under P4 – F1, this could be seen as simply another way of saying they will stay on the same path. Otherwise, this combination does not seem to have a plausible interpretation.

O. *P4 – F3*

This scenario says the three countries are already on the same path and that they will converge to a hybrid. As with P4 – F2, the only way of making sense of this scenario is as simply saying that they will remain on the same path.

P. *P4 – F4*

This final scenario says that the three countries are roughly similar, but that the United States might remain, or become, distinct from Japan and Germany. It has two possible interpretations.

In one, P4 is used in the variant that the United States is ahead of the other countries on their common path. P4 – F4 could then mean that the United States will remain ahead of Japan and Germany on this path. Japan and Germany may continue to learn from and imitate American innovations in corporate governance, but never fully catch up with the leader.

In the other interpretation, the three countries are on the same path, but in the future, they will diverge and actually evolve into distinctly different systems. On both efficiency/evolutionary and path dependence theories, it is rather hard to see how this might happen. Mark West, however, has an interesting recent empirical study of corporate law provisions that suggests that precisely this has happened in the evolution of those provisions in the United States and Japan over the past fifty years.¹⁶⁷ Perhaps what is true of those legal provisions may become true of the countries' overall systems. West's findings can be interpreted in a different way. The initially similar legal provisions were placed in two countries with quite different overall systems. The provisions then evolved differently in each country to adapt to the different needs of those two systems. I suspect that the same may have happened with the prohibition on bank ownership of stock in Japan and Germany.

Q. *My Best Guess*

That, then, is the set of possible combinations of my stories of the past and future. Before venturing a guess as to which scenario I find most likely, let me underscore a more basic point. Neither economic and legal

167. See WEST, *supra* note 130, at 11-28 (conducting experiment in corporate law in which one studies development of corporate law systems in two different institutional settings).

theory nor empirical evidence gives us much reason to confidently choose one square among the sixteen in Table 2. As to theory, although the theory of the firm has much of interest to say as to corporate governance, ultimately it cannot choose between the two competing systems. Each has its own strengths and weaknesses. Theory does a good job of describing and analyzing those strengths and weaknesses, but it cannot tell us which strengths and weaknesses will turn out to be empirically decisive.

We also lack a convincing theory that can assure us that, under certain circumstances, the most efficient approach to corporate governance will win out. If we did, although we might not be able to predict the outcome of the battle between these systems, at least we could say that in the end, when one won, that one was the most efficient. However, we really cannot even say that. Thus, if the American system does in the end come to dominate in Japan and Germany as well, we will not be able to tell whether the scenario followed was P1 – F1, P2 – F1, P3 – F1 or P4 – F1.

The problem becomes even more intractable when we add distributional equity and participation as values alongside efficiency. Moral and political philosophers have had even less luck sorting out those competing values than economists have had in comparing the efficiency of competing systems.

Moreover, empirical evidence on a question as broad and debated as this one is quite incomplete and multi-tongued.¹⁶⁸ Scholars on different sides can select among the evidence to support their position. The debate to date has been rather faddish based on the short-term success of the different countries.¹⁶⁹ This is particularly troubling when one considers that not only can and does short-term relative success change, but also the causal link between corporate governance differences and overall economic performance is quite suspect—other factors may well swamp differences in corporate governance. A highly incomplete listing of relevant factors includes differing natural resources, fiscal and monetary policy, educational systems, legal differences outside the area of corporate governance, culture, savings rates, demographic factors, the effects of World War II (the United States won, Japan and Germany lost), and so on.

Thus, those participants in the convergence debate who confidently predict convergence to a superior American way have no good basis for that confidence. Perhaps they are guilty of availability bias¹⁷⁰—as academics at elite American law schools they are mainly familiar with that American way, so when they ask how best to deal with the problems confronting corporations, the methods most available to them are the American methods, which they have spent their careers studying.

168. See Licht, *supra* note 34, at 161-62 (noting empirical evidence is mixed in comparative corporate governance scheme, especially concerning significance of shareholder activism).

169. See *id.* at 162 (asserting debate over corporate governance, most notably Japanese and German, has been "hot topic" over last few years).

170. See *supra* note 89 and accompanying text.

Therefore, my main point on the convergence debate is that there are more possibilities on this question than most commentators have tended to acknowledge, and we do not have much to go on in choosing among these possibilities. Having said that let me try to choose. You have been warned, though, about the likely accuracy of this choice.

Among the past stories, I favor P3. The two systems have complementary strengths and weaknesses in advancing efficiency. The Japanese system seems to have lagged over the past decade, but one should not be too caught up in short-term comparisons. In terms of promoting participation as well, it seems that the two systems have complementary strengths and weaknesses—Japan and German firms probably do better at promoting participation within the firm, but the United States does better at encouraging a wide variety of entrepreneurs to found their own firms. Japan and Germany would appear to be superior at promoting equality. Overall, it is hard to say that either system is clearly superior at this point. I do, however, think the differences between the United States and Japan and Germany are real, and therefore P4 is implausible.¹⁷¹

Choosing among the future stories is harder—not much of a surprise. Predicting convergence to the Japanese-German system (F2) under current circumstances would have the virtue of boldness, but I cannot say I possess that virtue in adequate quantities to make that prediction. That just does not seem to be where things are heading at this point. Choosing among the other three alternatives is harder, but the central tendency today seems to be convergence to a hybrid (F3), but one that is much closer to the United States than to Japan or Germany. In saying this, I am claiming that the four kinds of system effects are tending to yield to the pressures of international competition in both product and financial markets. Political defenses of the current system are still quite strong. However, continued crises in the Japanese financial system suggest that at some point the government will have to address the situation more seriously. In Germany, meanwhile, there is some movement to unwind the system of share crossholding and bank control, particularly with changes in the tax law due to take effect.¹⁷² Structural inter-relationships within systems may prove less of an impediment as firms become more able to enter into relationships with banks or capital markets from other countries. I do think, however, that such impediments may well prevent American firms and states from adopting some practices and laws which work well within the bank-centered system but not the market-centered system. This factor will make the convergence hybrid closer to the American system than a piece-by-piece comparison of best practices might suggest. Informational effects will diminish as people in different countries learn from each other. I

171. A wide variety of analysts, using a variety of techniques and arguments, have found significant systematic differences between the countries. See sources cited *supra* notes 7 and 35.

172. See generally Roe, *supra* note 28, at 171-72 (discussing pressure in Germany to reduce bank power and control in corporate structure).

doubt that broad values are an important part of the reason for differences between the United States, Japan and Germany in corporate governance, while more narrow norms can be changed. Consider, for instance, how the old norm among American corporate lawyers of not being involved in hostile takeovers collapsed.

As I have emphasized, the stories being considered here are ideal types. Reality lies in between them. I do not think any tendency to convergence will be at all quick or complete, by any means, nor do I think it is a good thing.¹⁷³ The persistence of a variety of system effects will greatly slow down any convergence, and for a long time significant differences will remain. For quite a while it may well be hard to tell whether the systems are converging at all. Moreover, remember my main caveat: it is quite possible that they are not.

VI. EVALUATING THE SCENARIOS

Section V laid out sixteen different scenarios relating the past and future stories of Sections III and IV. It then hesitantly, all-too-hesitantly, offered a prediction as to which of these scenarios was most likely. This section offers a normative evaluation of those scenarios.

It might seem that further normative evaluation is superfluous, given that such an evaluation is built into the past stories. Thus, suppose one accepts P1—namely, that the American system is superior. Does that not imply that one is committed to saying either that the preferred future path is F1, convergence to the American system, or perhaps F3, convergence to a hybrid, if that hybrid involves cherry-picking particular good practices from the Japanese-German system? If the American system is superior, then surely convergence to it (F1) is preferable to the two systems remaining distinct (F4), right?

Not so fast. There is value to maintaining international diversity in corporate governance circumstances. Perhaps the American system is superior under current economic circumstances. However, if circumstances change the Japanese-German system could conceivably become preferable, or be capable of evolving into a preferable system. Or, even setting aside changed circumstances, as the two systems continue to evolve the Japanese-German system may some day surpass the United States. Thus, even if we believe we can say one system is currently better than the other, one may question whether we can say that this comparison will necessarily remain true for all time to come.

Given this possibility, there is then value to be had from maintaining international diversity in corporate governance systems, so that we do not foreclose future alternatives and evolutionary possibilities. The argument resembles the argument for biodiversity in species.¹⁷⁴ We gain from pre-

173. See *infra* Section VI.

174. Cf. PAULO NUNES ET AL., ECOLOGICAL-ECONOMIC ANALYSIS AND VALUATION OF BIODIVERSITY 26 (Dep't of Spatial Econ., Free Univ., Working Paper No. 00-100/

serving even those species which do not seem to add much to the world at this point, because at some point in the future those species may become more valuable, for example, by becoming the source for a cure to a new disease.¹⁷⁵

This issue raises a new question about each system: How capable are they of evolving and adapting to changed circumstances and allowing new systems to take root, if that is what is most appropriate? If the currently superior system (if there is one) is unlikely to allow such evolution and adaptation, then there may be good reason to prefer that both systems remain in existence. On the other hand, if one system is quite adaptable, there may be less need to maintain a variety of systems. Offhand, the American market-based system seems likely to allow more experimentation and adaptation, but it is unclear whether it would encourage a move to the Japanese-German system should such a move become desirable in the future.

To the extent that the currently superior system would not allow adequate evolution and adaptation in the future, there is then a tradeoff between the current optimum—namely, convergence to the best system—and preparing for possible future changes in what is optimal. How one evaluates that tradeoff depends on how much one discounts the future and how likely it is that circumstances may change so as to make changing the system desirable, or that the currently inferior system may one day evolve to a superior system. It also depends, of course, on how much better the current system is. Personally, I think the case for maintaining diversity today, as a hedge against future change, is strong. Neither system is clearly and strongly superior today, and the chances of things changing significantly in the future appear good.

If I am right that P3 is the right past story, there is also a simpler reason why convergence may not be the best option. We could be converging toward the American system or a hybrid much closer to that system than to the alternative because international financial and product market competition favors the more efficient system, and the American system is currently more efficient. However, perhaps we should prefer the alternative system on distributional equity and/or participation grounds. Maintaining international diversity would allow those who want to live with a more efficient system to choose to live under that one, while those who prefer the fairness of the Japanese-German system could choose it. International competition may maintain that choice as well, but it may not, if the values of equity or participation are not able to adequately influence the selection mechanism.

It is possible, then, that current pressures for convergence may be too strong, even if that convergence is to the current best system, according to

3, 2001) (examining origin of study of biodiversity and its relation to human economic activities), available at http://www.feem.it/web/attiv/_attiv.html.

175. See generally *id.* at 3 (discussing species diversity).

some value. In considering international policymaking, both formal and informal, it may well be that we should be looking for ways to reduce, not increase, the pressure on Japanese and German decision-makers to follow the American example. On the other hand, if I am wrong and P1 (the American system has followed the superior path) is right, then preserving the Japanese-German system would allow Japanese and German firms to be left in a currently inferior state, to the harm of those countries. It is a hard judgment call.

VII. CONCLUSION

The core conclusion is that we cannot reach much of a conclusion—but that itself helps in thinking about what we should do. There are many possible paths, and we do not have any particularly compelling reasons or evidence pinpointing which we are on. Corporate governance systems may converge or they may not. If they do converge it may or may not be to the American system, and it may or may not be to the superior system. Even if they do converge to the currently superior system, that may not be a good outcome for the world economy.

It is good that American corporate law and governance scholars are now paying more attention to how the rest of the world works. It is not so good that so many of the most prominent of those scholars see this as a chance to proclaim American superiority and try to convince others to follow the American way. International comparisons open up a promising research agenda to students of corporations. Such comparisons make clear that there are many ways to deal with the challenges large corporations face. They provide some evidence for the relative strengths and weaknesses of those different methods and structures.

What we can conclude from that evidence, however, is still quite unclear. We lack adequate theory of both how different forms of corporate governance work and of how systems of corporate governance evolve and change. Few of those writing on the subject possess deep knowledge of the workings of corporate governance in several different countries,¹⁷⁶ and aside from the gang of four, almost no one is doing systematic comparative empirical research.

Given this pervasive lack of knowledge, those involved in national and international policymaking and advice giving should be careful about too vigorously advocating a one-size-fits-all prescription for corporate governance. Market forces may already be too strongly pushing firms in some countries toward convergence. These market forces may be supplemented by a variety of international policymaking and advice-giving organs, such as the World Bank, the International Monetary Fund and the Organisation for Economic Co-operation and Development. It is at this level that Hansmann and Kraakman discern an international consensus in

176. I am no exception to that statement, I hasten to note.

favor of the American model.¹⁷⁷ I think they discern that consensus only by ignoring many voices, but they may be right that those voices are growing harder to hear. The opposition voices need a stronger mike to help defend organizational diversity in both theory and practice. Even if market forces are pushing us toward convergence, those forces are not necessarily for the best, and we should not speed them along. We should slow down the process and keep our options open. That is why initiatives such as the Institute for International Corporate Governance and Responsibility are valuable. The Institute will bring together academics and practitioners interested in exploring and promoting alternatives to the American shareholder-dominant model.¹⁷⁸ Right now, such efforts are swimming against the current—and that is precisely why they are needed.

177. There has been an explosion of published guidelines for good corporate governance in many countries and by many organizations. See European Corporate Governance Network, *Corporate Codes, Principles, Recommendations and Laws*, at <http://www.ecgn.ulb.ac.be/ecgn/codes.htm> (last modified Sept. 19, 2001) (compiling full text corporate governance guidelines, principles of corporate governance and corporate governance reforms).

178. See International Institute for Corporate Governance & Accountability, *Welcome to IICGA*, at <http://128.164.132.19/iicga/> (last visited Jan. 8, 2002) (“The mission of the Institute is to study corporate governance systems and capital markets throughout the world and develop methods to devise and sustain responsible and accountable corporate behavior.”).

